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PREDATORY MORTGAGE LENDING PRACTICES: ABUSIVE USES OF YIELD SPREAD PREMIUMS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

THE ISSUES SURROUNDING THE USES AND MISUSES OF YIELD SPREAD PREMIUMS IN LIGHT OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT'S ANNOUNCED INTENTION OF PUTTING OUT A PROPOSED RULE ON THE REAL ESTATE SETTLEMENT PROCEDURES ACT

JANUARY 8, 2002

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TUESDAY, JANUARY 8, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:40 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

There are a number of people outside waiting. Are there any empty seats out there? We are going to try to move a few more people in. We may have them standing in the back. But if there is any way for people who are already in to tighten up a bit, we would appreciate that. And to the extent that we can add some others and they can stand in the back, we will try to do that as well in order to accommodate people.

This morning the Committee on Banking, Housing, and Urban Affairs will hold its third hearing on the subject of predatory lending. Our previous two hearings on this subject focused largely on the predatory loans and practices which have resulted in stripping hard-earned equity away from many low-income homeowners. These include folding high points and fees, as well as products such as credit insurance, into the loan. We examined in those hearings held this past July how unscrupulous lenders and mortgage brokers target low-income, elderly, and uneducated borrowers as likely marks for predatory loans.

Today, we are going to focus on the role of the broker in the lending process and specifically, we are going to focus on the use and misuse of what are referred to as yield spread premiums.

Let me start by addressing briefly how yield spreads are used in the marketplace. Typically, a mortgage broker will offer to shop for a mortgage on behalf of a consumer, the prospective borrower. In many cases, that broker will promise to get the borrower a good deal, meaning low rates and fees. Borrowers pay the broker a fee for this service, either out of their savings or with the proceeds of the loan. Unbeknownst to the borrower, however, that broker may also be paid a yield spread premium by the lender if he can get the borrower to sign up for a loan at a higher rate than the borrower qualifies for. The higher the mortgage rate, the higher the payment. And we will hear about such cases this morning.

Yield spread premiums, properly used, can be a tool in helping a homebuyer or homeowner offset all or some of the closing costs associated with buying or refinancing a home. When used properly, the broker discloses his total fee to the consumer. The consumer may then choose to pay that fee, and, perhaps other closing costs as well, by accepting a higher interest rate and having the lender pay the fee to the broker. In such cases where the borrower makes an informed choice the payment helps families overcome a barrier to homeownership—namely, the lack of funds for closing costs.

It is very important that this be transparent and that the borrower know exactly what their options are. But it appears that in practice, perhaps in widespread practice, yield spread premiums are not used to offset closing costs or broker fees. Instead, these premiums are used to pad the profits of mortgage brokers, without any regard to any services they may provide to the borrowers.

Let me quote from a report issued by the Financial Institutions Center at the Wharton School of Business at the University of Pennsylvania. Professor Emeritus Jack Guttentag, discussing the problem of rebate pricing—that is, payments by lenders to brokers of yield spread premiums,writes:

> In most cases, rebates can be pocketed by the broker, unless the broker commits to credit them to the borrower, which very few do. Rebate pricing—that is, yield spread premiums—has been growing in importance, and one of the reasons is that it helps mortgage brokers to conceal their profit on a transaction.

Moreover, this does not just affect subprime borrowers, as do most of the other egregious practices we heard about in our previous hearings. The misuse of yield spread premiums affects prime borrowers, FHA borrowers, VA borrowers. But, because of the lack of openness and competition in the subprime market, it hits subprime borrowers hardest of all. Even for those with the best credit, yield spread premiums can cost thousands of dollars in increased financing costs.

Yield spread premiums, when they are misused in this manner, fall directly into the category of the kind of referral fees or kickbacks that were so prevalent in the settlement business prior to the passage of RESPA—the Real Estate Settlement Procedure Act—enacted by Congress in 1974, after years of hearings and reports, and specifically designed to outlaw side payments of this kind because they increase the costs of homeownership for so many Americans. Indeed, the plain language of the law, the regulations, the 1998 Congressional instructions to HUD to formulate a policy on this issue, and the 1999 HUD policy statement, particularly when taking the legislative history into account, all make it clear that RESPA was intended to prohibit all payments that are not demonstrably and specifically for actual services provided. That is to say, each fee collected by the broker should be for a corresponding service actually provided.

Because the majority of home loans are now originated through brokers, lenders have less and less direct access to borrowers. This means they must compete for the broker's attention to gain access to the ultimate consumer—the borrower. This competition means that, too often, lenders pay yield spread premiums to the brokers simply for the referral of business. As all of us know, this is prohibited under the law precisely because it raises the cost of homeownership to the consumers.

Regrettably, HUD's recent clarification of its 1999 policy statement on the issue of yield spread premiums will open the door to new and ongoing abuses of low- and moderate-income homebuyers. Despite the Secretary's statement at his confirmation hearing that he finds predatory lending "abhorrent," I fear that the new policy statement will facilitate the predatory practice of steering homeowners to higher interest rate loans without their knowledge and, more importantly, without any effective means of redress.

Now, Secretary Martinez has made increasing minority homeownership a primary goal of his Administration. However, a study done by Howell Jackson of the Harvard Law School, who will be testifying on the second panel this morning, shows that while the current use of yield spread premiums imposes extra costs on all homebuyers, the burden falls especially heavy on minorities. In other words, yield spread premiums, when they are used in this abusive fashion, put the dream of homeownership further out of reach for minority Americans. Those who still manage to achieve the dream of homeownership are forced to pay thousands of dollars in increased interest costs over the life of their loans.

Many find themselves in more precarious financial positions than they should be, thereby putting them at greater risk of falling prey to the kind of repeated refinancing that we have seen leading to equity stripping or even the loss of the home.

HUD has indicated both in testimony before this Committee in December, and in a general announcement, that it intends to publish a proposed regulation on this matter by the end of this month. These issues are of such importance that they call for a public airing at this time, and that is the purpose of this hearing, so that the Department can take into consideration today's testimony as it considers formulating the new regulation.

We have two panels this morning. Let me just say in reference, and then I will introduce them in greater detail when they arrive, the second panel will consist of a number of experts from the academic world, consumer advocates, and from the business interests involved in the issues before us this morning.

The first panel that we will now turn to involves three witnesses who will testify about how their brokers steered them into higher rate mortgages in exchange for payments of yield spread premiums from the lenders. These are the mortgage brokers that each of these consumers went to and in the course of that process, they led them into a higher rate mortgage than they otherwise would have had to undertake. And the difference as a consequence was paid from the lender to the broker, not to the benefit of the consumers.

Beatrice Hiers is a Supply Management Representative for the General Services Administration and resides in Fort Washington, Maryland. Susan Johnson lives in Cottage Grove, Minnesota, outside of Minneapolis, and is a Manager at K–Mart. And Ms. Rita Herrod is retired and lives with her daughter and grandchildren in Clarksburg, West Virginia.

Before we take your testimony, let me express my very deep appreciation to all of you for your willingness to leave your homes and come here and be with us this morning and your willingness to speak publicly about your stories. I know that this can be a difficult thing to do. I just hope you understand how much we appreciate your willingness to contribute to a process that I hope will lead to some action to stop the kinds of practices that caused each of you such heartache, such difficulty, and such trouble.

I want to point out that these three witnesses include a prime borrower, a subprime borrower, and an FHA borrower. It is important to mention this so that everyone understands how the abuse of yield spread premiums can affect people, whatever their credit rating and whatever type of mortgage they receive.

Now, I will turn to you, Ms. Hiers. We will hear from you first and then we will go to Ms. Herrod and then Ms. Johnson. We will just move right across the panel, and we will hear from each of you first before I go to any questions.

Again thank you very much for coming and being with us this morning.

Ms. Hiers, I think if you pull that microphone closer to you and talk right into it, it will be more audible.

STATEMENT OF BEATRICE HIERS
FORT WASHINGTON, MARYLAND

Ms. HIERS. Good morning. I am Beatrice Hiers, and thank you for inviting me here today.

I am 43 years old and live in Fort Washington, Maryland. I have two children, Ebony, 22, and Zachary, 11. In addition, prior to their recent deaths, my elderly parents lived with me. I have worked hard and overcome many obstacles to purchase my own home.

I grew up in Prince George's County, Maryland. My family lived in a neighborhood that was not racially mixed. In fact, we were the first blacks on the street. In 1974, I received a general equivalency degree and went to work for Prince George's County Department of Social Services. In 1979, I began working for the Federal Government as a clerk/typist. Over the past 20 years, I have worked my way up to my current position as a Supply Management Representative for the General Services Administration.

Prior to purchasing my own home in August 1997, I struggled financially. I was a single parent and also helped support my parents. I began to think about moving and buying a home because the neighborhood in which I lived had become a "drug haven." I felt that it was important for my children and parents to get into a new environment that offered safety and security.

In June 1997, after house hunting for close to a year, I finally found a house that I wanted. I signed a contract to purchase the house for $159,750, but was told by my real estate agent that I needed to obtain my own financing. Because I was inexperienced with real estate transactions, I engaged the services of Homebuyers Mortgage Company, a mortgage broker located in Prince George's County, and asked them to find me a 7 percent or better "fixed" rate FHA mortgage loan, a rate equal to what another lender—Countrywide Home Loans—was willing to offer me.

The closing on the home was scheduled for August 29, 1997. As the settlement approached, I became increasingly nervous because Homeowners had not confirmed that it had located a mortgage for me. As late as just 2 days before the closing, Homebuyers told me that a firm commitment on financing was not yet available. Even though mortgage rates were low and favorable in August 1997, on the day of closing, Homebuyers finally told me that it had arranged a 7 percent “adjustable rate” FHA insured mortgage loan through Inland Mortgage Company, which is now Irwin Mortgage Company. Homebuyers told me that Inland was providing me with the best rate and most favorable financing terms that they could secure. Reluctantly, and believing that I had no other options, I entered into the mortgage loan transaction.

Homebuyers charged me extraordinary fees and points. My HUD–1 Settlement Statement reveals that Homebuyers charged me the FHA maximum 1 percent origination point, $1,544, plus loan discount points of 3 percent, $4,736. On top of these fees, Homebuyers also collected a yield spread premium from Inland of nearly 3 percent—an astonishing $4,538.87. In other words, I paid 3 discount points to reduce my interest rate and the broker was paid 3 percent by Inland to increase my interest rate.

Almost a year after I entered into the mortgage loan transaction, I learned that Homebuyers had not obtained for me the most favorable financing terms. In fact, I learned that Homebuyers was paid the $4,538.87 Yield Spread Premium by Inland Mortgage solely because Homebuyers was able to deliver my mortgage well above par—that is, Inland would have been willing to underwrite my mortgage loan at a lower interest rate. Moreover, I learned that Homebuyers’ yield spread premium was increased because Homebuyers delivered the mortgage loan with a short lock in period. Irwin’s rate sheet, in fact, shows that I qualified for the same loan at about 5½ percent interest rate with no yield spread premium to the broker.

What truly amazes me is that for the small amount of work performed for me, Homebuyers collected more than $10,800, including the yield spread premium. Moreover, had I known that Homebuyers had secured for me a mortgage with an above-par interest rate, I would have secured other financing.

Eventually, because the payments under Inland’s adjustable rate mortgage were becoming prohibitive, I engaged the services of another mortgage broker, Allied Mortgage, to assist me in the refinancing of my loan. I have since learned that this transaction included the payment of a yield spread premium, and resulted in my receiving another loan at a higher interest rate than I qualified for.

After completing these two mortgage transactions, I learned what yield spread premiums are and how they affected my mortgage loan and increased my monthly mortgage payments. As a result, I recently refinanced my home a second time, but this time directly with a lender. Because of my experiences with mortgage brokers and yield spread premiums, I will never go to a mortgage broker again.

Thank you again for inviting me and for your attention to these important issues.

Chairman SARBANES. Well, thank you very much for your statement. It is a very clear statement of the problem that we are quite concerned about.

You actually paid extra to try to get a lower rate, interest rate, discount points, at the same time that your broker led you into a higher interest rate in order to get the yield spread premium. Is that correct?

Ms. HIERS. Correct.

Chairman SARBANES. Ms. Herrod, we would be happy to hear from you.

STATEMENT OF RITA HERROD
CLARKSBURG, WEST VIRGINIA

Ms. HERROD. I am glad to have the chance to come here today and tell what happened to me so that others are not treated the way I have been treated. My name is Rita Herrod, and I am a 62-year-old mother, grandmother, and now, great-grandmother. I am currently disabled and unable to work. I live with my daughter and grandchildren, and I own my home with my daughter.

In July 1994, I bought a house in Clarksburg, West Virginia, for $22,000 for my daughter, Jennifer, and her children. About 4 years later, when I divorced my husband of 34 years, I moved into the house with my daughter and grandchildren, and I live there today.

In 1999, my daughter and I took out a loan to make improvements on the house. We got a decent loan from a local bank for 15 years with a variable rate beginning at 7.8 percent. I would end up not getting much benefit of this loan.

In early 2000, my troubles started when we encountered a mortgage broker we thought we could trust, Earl Young. My daughter Jennifer was working for Heilig Myers, where she met Mr. Young. Mr. Young, who worked for First Security, distributed his card to my daughter for her to distribute to others. Because my daughter knew Mr. Young and we had some bills to pay, we responded to his solicitation in April 2000.

Mr. Young told us he would get us a home loan with a lower interest rate on our current loan. He told us he was going to search and find for us the best deal he could.

Mr. Young arranged for an appraisal of our house. He said not to worry that I was not working and not to worry about the rumors that my daughter would be laid off in the near future. The appraisal he got for my house, I found out later, was for far more than it was worth.

We closed the loan the next month. We had to meet at Mr. Young's office. He seemed to have taken care of everything. He told us he was giving us a good deal. He said that our appraisal did not come back at what they wanted, so he agreed to cut his own fees to work the deal.

I wonder now what part of his fees Mr. Young cut. He charged us an origination fee of $4,000, a broker fee of $2,600, and I learned from my lawyer that he got a kickback from the mortgage company of $3,304 for getting me into a higher interest rate.

My loan was for just under $85,000, and I ended up paying over $10,000 in fees to Mr. Young. Now, I say that Mr. Young appeared to take care of everything, but I do not think he did $10,000 worth of work on my loan. He took our information and arranged for an appraisal. I do not know what else he did, but I know the mortgage company faxed him all the papers. I had no idea I was going to have to pay him so much, and I cannot for the life of me figure out what I got in return. And while I guess Mr. Young charged me $4,000 commission for finding the loan, and $2,600 for his fees, I have no idea what he did to earn the extra $3,304. Had I known $10,000 was going to be tacked onto the loan, I would never have done it. Had the broker not taken a kickback, I would have at least had a rate of 8.5 percent, maybe lower. Instead, I got a loan up near 10 percent.

I now have a loan that far exceeds the value of my house, making it so I cannot take advantage of lower interest rates and refinance. I am stuck with this loan, which requires that I make over $275,000 in payments at an APR of almost 10 percent. At the very worst, I could have stayed with my old loan, avoided the extra fees, and dealt some other way with my bills instead of putting them into my home.

I do not have any problem with people helping folks find a loan to help them out of a bind, or get them a good deal. But I do not think it is right for a broker to take a secret kickback of over $3,300, when they already are getting almost $7,000 in other fees. And I do not think it was worth $10,000 to get a loan that is worse than what I had, when there are much better deals out there. We trusted Mr. Young, because we thought it was his job to find us the best deal. But instead, he cheated us out of a lower interest rate and $10,000.

Thank you.

Chairman SARBANES. Thank you very much, Ms. Herrod. We appreciate your very powerful testimony.

Ms. Johnson.

STATEMENT OF SUSAN M. JOHNSON COTTAGE GROVE, MINNESOTA

Ms. JOHNSON. Good Morning. My name is Susan Johnson and I am from Cottage Grove, Minnesota. I am pleased to have the opportunity to be able to address——

Chairman SARBANES. I think you are going to need to pull that microphone closer to you because it does not pick up very well unless you get it right up close to you.

Ms. JOHNSON. I am pleased to have the opportunity to be able to address the Senate Banking Committee today about the $1,620 yield spread premium that was secretly paid by my lender, ABN AMRO Mortgage Group, to my mortgage broker, Allstate Mortgage, at my expense.

In April 2000, my husband David and I had just moved back to the Twin Cities from Colorado Springs and were looking to buy a house. Through a real estate agent, we were introduced to David Schultz, the owner of Allstate Mortgage, a mortgage broker in Plymouth, Minnesota. After meeting Mr. Schultz at a local restaurant, we hired him to find us a mortgage loan.

From the outset, we were told by Mr. Schultz that he would find us a loan with the best possible rate. Mr. Schultz specifically told us that the fee of processing the loan would be 1 percent of the loan amount. We signed a written broker agreement with Mr. Schultz which allowed for a 1 percent broker fee. No other fees were ever demanded by Mr. Schultz, discussed, or agreed to.

When the closing occurred on May 23, 2000, to our surprise, the interest rate was higher than we understood it would be and the fees were far greater than the 1 percent fee we had agreed to. In fact, the total fees were nearly four times that amount, $5,242. This included what we only later came to learn after the closing was a yield spread premium—a $1,620 payment from the lender to our broker that was really paid by us since it was tied to an inflated interest rate on our loan.

While we were upset about the fees, we had no choice but to go through with the closing or risk losing the house, being found in default of the purchase agreement; and forfeiting the $5,000 earnest money down we had already given the sellers. While we objected to the fees and higher interest rate, there was no way for us to find another loan and still close on time. We were stuck and the broker knew it.

As our HUD–1 Settlement Statement shows, we were charged the following fees at closing, none of which was disclosed, or agreed to, beyond the initial 1 percent origination fee: $1,296 loan origination fee; $1,292 loan discount fee; $395 processing fee; $200 underwriting fee; $150 doc prep fee; $40 funding fee; $350 commitment fee; and $285 admin fee.

Only after the closing did we discover the significance of the $1,620 yield spread premium which was assessed to us through an inflated above-par interest rate of 8.75 percent. At the time of the closing, we had no idea what this premium was because it was only vaguely disclosed on our HUD–1 Settlement Statement as a Deferred Premium POC. In sum: The $1,620 yield spread premium was not disclosed, discussed, or agreed to before the closing; my husband and I were never informed that our loan had an above-par interest rate because of the premium payment from ABN AMRO to the broker; the broker never explained how the yield spread premium affected our interest rate or that our monthly mortgage payments would be any higher because of the premium; no rate sheet or other document showing the direct relationship between the inflated interest rate and the yield spread premium payment from the lender to the broker was ever shown to us; the yield spread premium did not offset or reduce any fee we ever owed to the broker; the broker received all fees that we owed and agreed to—and far more—directly in cash from us at the closing.

After the closing, I wrote to the State of Minnesota Department of Commerce complaining about the transaction. After reviewing my letter, the Department of Commerce advised us to seek private legal counsel. The matter remains pending in court in Minnesota. In that case, we have agreed to be representatives of other borrowers whose loans had yield spread premiums paid by the same lender in the same manner as ours.

In conclusion, the $1,620 yield spread premium on our loan was nothing more than a bonus paid by the lender to the broker for securing a bad deal for my husband and me, and referring a better deal to the lender. This conduct should be illegal because: The yield spread premium was not paid in exchange for any service fee we owed to the broker; We received no benefit from the premium the lender paid at our expense, such as an offsetting credit against any closing fees or costs we actually owed, and the money was simply a kickback to the broker referring our loan to the lender with a higher interest rate.

The standard for evaluating the legality of this practice should not merely be whether the broker's total compensation, including the yield spread premium and other fees we never agreed to, is somehow reasonable based on the broker's after-the-fact attempt to justify the higher fees he has already taken. Rather, the true nature of the disputed premium should be evaluated: That is, what was the premium actually paid in exchange for.

To allow as lax a standard as "reasonableness" of total broker compensation to govern these transactions will only allow lenders and brokers like ABN AMRO and Mr. Schultz to continue ripping-off unknowing consumers like us, with a catch-us-if-you-can attitude. It will encourage brokers and lenders to continue to try to slip additional bonus fees into mortgage transactions regardless of what was agreed and without providing any actual credit to the consumer bearing the cost. If lenders are paying bonuses and incentives to brokers simply for referring high-rate loans to them, that should be illegal without concern for whether the broker or lender thought the secret referral fee was reasonable.

Thank you again for giving me the opportunity to speak today.

Chairman SARBANES. Thank you for coming this morning.

One thing I find very interesting about all three of your stories is that, in each case, you were led to believe that the mortgage broker would work to find a loan that was in your best interest. You all proceeded ahead on the impression or, really, the understanding, that this broker was going to do the best that he could for your interest. Is that correct?

Ms. JOHNSON. [Nods in the affirmative.]

Ms. HIERS. [Nods in the affirmative.]

Ms. HERROD. [Nods in the affirmative.]

Chairman SARBANES. So you placed confidence in the broker. You did not see the broker as a party on the other side of the table. You actually saw him on your side of the table. Is that correct?

Ms. HIERS. [Nods in the affirmative.]

Ms. JOHNSON. [Nods in the affirmative.]

Ms. HERROD. [Nods in the affirmative.]

Chairman SARBANES. You had better say yes because he cannot get nods.

[Laughter.]

Ms. HIERS. Yes.

Ms. JOHNSON. Yes.

Ms. HERROD. Yes.

Chairman SARBANES. Now each of you ended up paying a higher interest rate than you would otherwise qualify for, in addition to paying substantial upfront costs.

And one of the things, your statements outline the extra fees and charges involved at the time of settlement. We have not gone into the extra cost to you over the life of the loan as a consequence that you would be paying a higher interest rate. That makes a very significant difference in your monthly payment and your overall payment through the cost of the loan, whether you got the lower or the higher interest rate.

So another cost to you that is not reflected in the statement, one would have to calculate it out by what the difference was in the interest rates and the amount of your loan. But in any event, it is clear that there is a substantial additional charge to each of you over the life of the loan because you are paying at a higher interest rate than you otherwise might have had available to you.

Now, I want to make sure that I understand what each of you paid in fees for your loans.

Ms. Hiers, let me start with you first. When you went to the mortgage broker, I gather you understood that you could qualify for a 7 percent fixed-rate loan with another lender. Is that correct?

Ms. HIERS. That is correct.

Chairman SARBANES. And when you decided to move forward with this broker, I take it it was in the belief that the mortgage broker was going to get you a better rate and be able to do better for you than that. Is that correct? That is why you went ahead with using the broker.

Ms. HIERS. That is correct.

Chairman SARBANES. Now, in the end, this broker got you an adjustable-rate loan at 7 percent, not a fixed-rate loan. Is that correct?

Ms. HIERS. That is correct.

Chairman SARBANES. Which I gather was about one and a half points above what you might have qualified for, as you understood it, later understood it.

Ms. HIERS. At an adjustable rate, yes.

Chairman SARBANES. Now, you did not know you would be getting a less favorable loan until just before the closing. Is that right?

Ms. HIERS. The day of closing.

Chairman SARBANES. The day of closing.

Ms. HIERS. In the 12th hour.

Chairman SARBANES. And, of course, at that point, I gather you did not feel that you were in any position to walk away from this and try to find another loan. Correct?

Ms. HIERS. Correct.

Chairman SARBANES. I mean, did you find it out right at closing?

Ms. HIERS. At closing.

Chairman SARBANES. Right at closing.

Ms. HIERS. Right at closing.

Chairman SARBANES. Did you know prior to closing that because you were getting a loan at such a high interest rate, the mortgage broker was being paid a yield spread premium of almost 3 percent? Did the broker ever discuss this yield spread premium with you and explain what the premium was for?

Ms. HIERS. No. No.

Chairman SARBANES. That was just over $4,500 in the yield spread premium that the broker was getting from the lender.

Ms. HIERS. Exactly.

Chairman SARBANES. And, of course, you did not know about that.

Ms. HIERS. I was not aware of it.

Chairman SARBANES. Now, you say that you also paid 3 discount points as well. Did the broker explain to you that these discount points would bring down the interest rate on your loan, that that was the purpose of the discount points?

Ms. HIERS. The broker did not explain any of the fees to me. The day that I was supposed to go to settlement, my loan was not approved. It was not approved. It was a Friday evening. My loan was not approved until about 4:00 in the afternoon. The sellers had to go to settlement also that day and there was nothing explained. Everything was held until the 12th hour. Everything was held and none of the fees were explained to me. I later found out about the yield spread premiums.

Chairman SARBANES. And it was only subsequently that you discovered that they had not gotten the most favorable financing terms and that they had been paid a yield spread premium.

Ms. HIERS. Right.

Chairman SARBANES. So what happened to you, in effect, is you took on this broker. You had a contract to purchase the home for just under $160,000. The broker charged you a 1 percent origination point, the FHA maximum, I take it, at the time, for $1,500. You paid these loan discount points of 3 percent, $4,736. That, of course, was to get your interest rate down. Then the broker turned around and he got a nearly 3 percent yield spread premium from the lender, which was worth to him $4,538.

So your broker got almost $11,000 out of this arrangement. And the upshot of it was to put you into a significantly higher-rate mortgage than would otherwise have been the case. Is that correct?

Ms. HIERS. That is correct.

Chairman SARBANES. In addition, I have a work sheet that we have prepared here that indicates that over the life of this mortgage, you will pay an extra $56,000 in interest, from what you would have paid if you had had the interest rate for which you qualified.

I know it is a little awkward to lay all of this out like this, but I think it is important to do it because there are lots of people out there that are subject to the same thing and we want to send a very strong warning signal and we appreciate your coming this morning to help us do that.

Now, Ms. Herrod, let me ask you just a few questions about your situation. First of all, you are currently disabled. But I gather that previously, you were working. Is that correct?

Ms. HERROD. Correct.

Chairman SARBANES. What did you do, Ms. Herrod?

Ms. HERROD. I was a buyer at a pharmacy, customer service, and buying and inventory. I had to have surgery on Valentine's Day of 2000. And when I told my employer, I asked him if he had any compensation for me. He said, no. He said, I have to make some cuts, economic cuts, and I was one of the higher-paid employees. So, I was given a 3 months severance pay, which ended May 31. And I had told Mr. Young in April, I said, I am going to be out of income next month. And he said, it does not matter, as long as you have income today.

Chairman SARBANES. Ms. Hiers, you worked for your general equivalency degree and then worked for the Department of Social Services in Prince George's County.

Ms. HIERS. That is correct.

Chairman SARBANES. And then went to work for the Federal Government, beginning as a clerk/typist, I gather.

Ms. HIERS. Yes.

Chairman SARBANES. But then you worked your way up, and now you are a Supply Management Representative for the General Services Administration. Correct?

Ms. HIERS. That is correct.

Chairman SARBANES. Ms. Johnson, were you employed?

Ms. JOHNSON. Yes.

Chairman SARBANES. What were you doing? Or what do you do?

Ms. JOHNSON. I am a Unit Pricing Manager at K–Mart.

Chairman SARBANES. Okay. I ask these questions only to underscore the fact that you are all three hard-working people who have been gainfully employed and contributing to the economy and, in a sense, playing by the rules and trying to own a home and realize that, make things better for your family and so forth and so on. It is extremely distressing to see these efforts at exploiting you.

Now, Ms. Herrod, you had a variable rate loan which started at 7.8 percent. Correct? In the beginning.

Ms. HERROD. In the beginning.

Chairman SARBANES. You wanted to refinance, hopefully to bring down your payments. And also, you wanted to consolidate some debts and pay them off. Is that correct?

Ms. HERROD. Yes.

Chairman SARBANES. But the loan that Mr. Young, your broker, got—I am not sure I should call him your broker. The loan that Mr. Young, the broker, got for you was close to 10 percent. Is that right?

Ms. HERROD. Right. I think it was 9, maybe 9 point something.

Chairman SARBANES. Yes. Did you understand prior to the closing that your interest rate was going to be so much higher than the loan you already had?

Ms. HERROD. No.

Chairman SARBANES. Now in addition to paying this higher interest rate, I see you paid Mr. Young an origination fee of $4,000, while also paying a broker fee of $2,600.

Ms. HERROD. Right.

Chairman SARBANES. Is that correct?

Ms. HERROD. Yes.

Chairman SARBANES. So, $6,600 in all. Did you know at the time you closed that he was also going to get another $3,300 from the lender for leading you into a higher-rate interest?

Ms. HERROD. No, we found that out from the attorney after the fact when we were faced with losing our home.

Chairman SARBANES. When you agreed to work with Mr. Young at the beginning, after you met him, did you believe that he would find you the best deal on a mortgage? Is that what was indicated?

Ms. HERROD. Yes. I had excellent credit, above and beyond. It was irreproachable.

Chairman SARBANES. So, you thought that he was really going to look after your interests.

Ms. HERROD. Correct.

Chairman SARBANES. That is the assumption you worked on when you went into this arrangement. Instead, he ended up getting

$10,000 out of this arrangement and you got a loan at 10 percent interest. Correct?

Ms. HERROD. Correct.

Chairman SARBANES. Now, Ms. Johnson, I see you paid a large amount of fees in addition to the broker receiving a yield spread premium in your instance.

Ms. JOHNSON. Yes.

Chairman SARBANES. He told you, the broker at the outset, that his fees were 1 percent of the loan amount, or that is what you understood. Is that correct?

Ms. JOHNSON. Yes, it is.

Chairman SARBANES. And it was your understanding that this would be what he received out of his efforts, 1 percent of the loan amount. Correct?

Ms. JOHNSON. Correct.

Chairman SARBANES. But, then, when you got to closing, you found that the fees were far greater than the 1 percent that you had agreed to.

Ms. JOHNSON. Yes.

Chairman SARBANES. In fact, they were over $5,000, the fees.

Ms. JOHNSON. Yes, they were.

Chairman SARBANES. You did not know those extra fees were coming. In fact, you were operating on the premise that the broker fee would be 1 percent of the loan amount. Correct?

Ms. JOHNSON. Yes.

Chairman SARBANES. Now, were you aware that the broker was also over and above this $5,200 receiving a yield spread premium from the lender because he was leading you into a loan with a higher interest rate than what you qualified for?

Ms. JOHNSON. No, he never——

Chairman SARBANES. You did not know that. And so, later on, you found out that that was the case, that he was getting that yield spread premium as well.

Ms. JOHNSON. Yes.

Chairman SARBANES. You also, I take it, believed that the broker was working on your side to put together the best financing arrangement that he could on your behalf. Were you proceeding on that assumption?

Ms. JOHNSON. Yes. We asked him to, and he said he had several places he could go to and he would do the best for us.

Chairman SARBANES. Well, I want to thank all three of you for coming this morning. These, in a way, are very sad stories because they are a very dramatic illustration of people being exploited, in my view, being the victims of abusive practices.

People are entitled to get a fair return for services that they provide. Brokers, along with everyone else, are entitled to that. But they are not entitled to take advantage of people, to abuse people, to lead people in placing their confidence in them and then exploiting that confidence to gain an egregious return at your expense, and that is what we are setting out to try to accomplish with these hearings.

Not only to charge you these high fees, but by getting the yield spread premium, about which none of you knew anything about, leading you into a higher interest rate mortgage than otherwise would have been the case and saddling you, then, with those extra costs and charges over the life of the mortgage.

In each instance, I gather, all of you were in a sense sacrificing or pushing yourselves to the limit in order to be a homeowner, which of course would help you to meet very important family responsibilities. And yet, you had people who were in effect almost shoving you over the line in terms of your ability to handle—I guess all of you, really, found yourselves in a much more constrained financial position as a consequence of these abuses that you were subjected to.

So thank you very much for coming this morning and giving us this very powerful testimony. We appreciate it very much.

Ms. JOHNSON. Thank you.

Ms. HERROD. Thank you.

Ms. HIERS. Thank you.

Chairman SARBANES. We will now turn to the second panel and we will excuse our three witnesses.

[Pause.]

I want to welcome the second panel here this morning. Because this is a relatively large panel, I will introduce each witness separately, just before we hear from them. We will move across the panel and take the testimony of all the witnesses before we turn to the question period.

Your full statements will be included in the record and if you can abbreviate it orally to something in the range of 5 minutes or so, we would appreciate that very much, although we are anxious that you feel that you have had an opportunity to make your major points. That is the prime objective, not the time restraint. But we are trying to balance the two here this morning.

Our first witness is Howell Jackson. Mr. Jackson is Associate Dean for Research and Special Programs and the Finn M.W. Caspersen and Household International Professor of Law at Harvard Law School.

His research currently deals with problems in consumer finance, comparative cost benefit analysis of financial regulation and other topics.

Prior to joining the Harvard Law School faculty in 1989, Professor Jackson served as Law Clerk to U.S. Supreme Court Justice Thurgood Marshall and practiced law in Washington. He received his law degree and an MBA from Harvard University in 1982.

Mr. Jackson, we would be happy to hear from you.

STATEMENT OF HOWELL E. JACKSON FINN M.W. CASPERSEN AND HOUSEHOLD INTERNATIONAL PROFESSOR OF LAW AND ASSOCIATE DEAN FOR RESEARCH AND SPECIAL PROGRAMS HARVARD UNIVERSITY SCHOOL OF LAW

Mr. JACKSON. Thank you very much, Chairman Sarbanes.

I am pleased to be here and what I would like to do with my oral comments is just to summarize my written testimony and, in a sense, build on the testimony that we have already heard this morning.

The impetus of today's hearings is the HUD's Statement of Policy regarding yield spread premiums. What I want to talk about initially is their factual assumptions about what was going on in the industry with yield spread premiums.

They have a view that yield spread premiums are a legitimate financing tool that is particularly useful for borrowers who are short on cash and need to use the tool to finance upfront costs.

This morning's witnesses have already demonstrated that that is certainly not always the case, that there are often instances when the yield spread premiums are often used to raise the cost for individual borrowers.

But what I would like to talk about is a study that I have conducted that looks at the practice more broadly. And in brief, what my study shows is these witnesses are not atypical, that this is actually going on on a widespread basis, across the industry, and harming substantial numbers of consumers.

Let me just begin by saying that I would reiterate the statements of the witnesses that yield spread premiums are not being presented as an option to borrowers. The HUD consumer guidance, the industry discussions of the subject, it is just clear that these payments are not being described as optional sorts of financing for particular consumers. They are being imposed without consumers understanding what is going on. I think that is fairly clear.

It is also fairly clear from my study that they are not specialized sorts of financing that are used upon occasion. Their practice is widespread. In my study, between 85 and 90 percent of consumers were paying some yield spread premiums. The average amount of these payments was $1,800 per consumer, which is a large amount of money.

They are the most substantial source of compensation for the mortgage broker industry, according to my study. So, they are very significant and they are very substantial for the industry.

It is also the case that it is clearly not being limited to borrowers who lack cash to pay upfront costs. Just the number of 85 to 90 percent shows that there are many borrowers who could pay the upfront costs in other ways, were they told that that is what was going on. But we also examined the loans in question and many of the borrowers could simply have increased the loan amount. It would have been a much more efficient way to finance their settlement costs, their costs of closing. Yet, the brokers still steered them into yield spread premiums. So this is not limited to a small number of borrowers. It is a widespread practice and our study I think demonstrates that quite clearly.

Another point that is important to understand is the mortgage broker industry cannot be indifferent to yield spread premiums. The HUD policy statement suggests that it is just another kind of financing. But our analysis indicates that mortgage brokers make substantially more money on loans with yield spread premiums. The average amount of additional compensation, according to our study, is over $1,000, $1,046 of extra compensation from mortgage brokers receiving this kind of payment than the compensation they would receive on other kinds of loans without yield spread premiums. So the amount of money is quite substantial. And I think that explains why this issue is so hotly contested.

Now as an economic matter, one of the interesting questions about the yield spread premiums is are they being used to offset other costs? The additional compensation I just mentioned would suggest that is not going on, and certainly this morning's testimony, the witnesses we heard today, suggested in their cases they were not getting any reduction. In fact, it sounds like their other costs were quite high compared to industry averages.

We did a large-scale study to see what the standard offset was in a sample of 3,000 loans. And what we discovered is the vast majority of yield spread premiums goes simply to increase the compensation of mortgage brokers. They do not go to reduced upfront costs.

Our best estimate, and there are definitely different ways of doing this estimate, is that, on average, consumers get 25 cents on the dollar for every dollar extracted in yield spread premiums.

So 75 percent, the vast majority, go to the mortgage broker industry to increase their compensation. And I think that really indicates the nature of the practice.

This is not a case of a small number of atypical consumers who are paying exorbitant fees. Certainly that is also going on. But the main point is, on average, the offset is very low. The value, if you will, to the consumer of yield spread premiums is very, very poor.

Now the industry sometimes likes to characterize yield spread premiums as a form of financing as a way of financing upfront costs. And we did this calculation similar to the calculation that you were suggesting earlier—how much more in additional interest payments down the road are consumers taking on? What value are they getting for it? And if you work out the numbers, it is frankly embarrassing. The interest rate is 114 percent per annum, according to our estimate. Maybe 90 percent per annum. It is just off the charts of acceptable interest rates. My study was dealing primarily with middle-class borrowers who would have excellent credit histories and be deserving of much lower interest costs. So as a form of financing, these payments are just usurious.

Another factual point I would make about our study and its implications is, on average, yield spread premiums generate higher compensation and higher costs for borrowers. But it is also the case that there are a lot of examples of individuals who pay way more than average.

If you try to look at the average compensation to mortgage brokers in these loans, it varies greatly. It seems to me that there is a lot of price discrimination going on here. There is a lot of picking off the soft targets—the less well-educated, the less financially sophisticated consumers, and using this disguise payment practice to charge them more. And this is something that I want to examine more, but you mentioned this aspect of my study and I just want to call the Committee's attention to it.

If you look at the racial identity of the borrowers and measure it against mortgage broker compensation, you see that mortgage brokers are making a lot more money on minority borrowers.

According to our study, African-Americans are paying about $474 more on average. Hispanic-Americans, paying about $580 more on average than other borrowers. And that is after controlling for the credit quality, the credit score they got, the kind of loan they had, the loan-to-value ratio. It is controlling for the credit aspects. And it seems to be that these groups who are traditionally less well-educated, less financially sophisticated, are being picked off here, and I think that is one of the most disturbing things about our findings.

Now the HUD policy statement goes on and talks about a number of legal issues. I am happy to deal with them in questions and answers. But I just want to focus on the connection between what I think is the Department's misunderstanding of the role of yield spread premiums and their legal analysis. They characterize these payments as a way of reducing upfront costs. And if the payment is for goods and services, it is tested under a relatively liberal standard, lenient standard, under the HUD rules.

What my study shows and what the evidence you heard this morning suggests is these payments are not being used principally for goods and services or principally for reducing upfront costs. They are serving principally to increase compensation. And for that reason, I think a more stringent legal standard is appropriate.

Fortunately, the Department is considering a number of rulemaking proposals to change practices to help consumers in the future. I think that there is a lot that can be done prospectively to improve things for consumers with the right changes. I have four changes, specific proposals in my testimony. Let me just highlight them in conclusion here.

First, if mortgage brokers are going to be recommending loans with yield spread premiums, it should be presented as an option. The mortgage broker should also be required to say to Ms. Johnson and her colleagues that another loan is available at a lower rate. If it is going to be an option, it should be presented as an option and the Department should mandate that.

Second, when a consumer chooses to take an above-par loan, and sometimes it might make sense, the proceeds of the extra interest, the yield spread premium, should be given to the borrower. The borrower can use it to pay for the house, to pay for other costs, to pay for other payments to the mortgage broker, or to take home in his or her pocket. But the money should be given to the borrower if it is used for the borrower's benefit. What that means is it has to become a credit on line 200 of the HUD–1 form.

Chairman SARBANES. The theory being that the borrower, in a sense, has paid for it by agreeing to a higher interest rate over the life of the loan. Is that correct?

Mr. JACKSON. That is exactly right. If the borrower is getting this money through paying for it, the borrower should receive it and then see specifically what services the broker is trying to charge for. I think this is a very important step that needs to be taken.

There are other steps, too. I think the practice of mortgage brokers charging discount fees, as we saw in the case of Ms. Hiers and Ms. Johnson this morning, is simply misleading.

The brokers are not using those discount points to lower interest rates. It is simply a disguised form of interest spread premium and I think the best solution to this problem is to ban it. There is an appropriate role for discount fees, but it is not to pay to brokers in these contexts.

Chairman SARBANES. Actually, if they do that, they can get the consumer going and coming—getting him on the discount fees and then they get him on the yield spread premiums. Right?

Mr. JACKSON. That is right. It is unbelievable that brokers are charging consumers fees for lowering interest rates on loans that have interest rates above par. It is just unfathomable how this practice could be tolerated, in my view.

Finally, I think the Department needs to look also at direct lenders. There needs to be a quality in the industry between direct lenders and mortgage brokers. However, I would not let concerns about direct lenders stop the Committee and the Department from going forward today.

Mortgage brokers are the primary supplier of mortgages in the United States at this time. They should be the primary focus of the HUD reforms. We should solve the problem here first and then we can take care of other aspects of the industry later. But I think the time is now to go forward.

Thank you.

Chairman SARBANES. Thank you very much, sir.

Now, we will hear from John Courson, President and Chief Executive Officer of Central Pacific Mortgage Company, and Chairman-elect of the Mortgage Bankers Association of America.

Prior to assuming his current position, Mr. Courson served as President and Chief Executive Officer of Westwood Mortgage Corporation and as President and Chief Operating Officer of Fundamental Mortgage.

Mr. Courson was a very helpful witness in previous hearings held by this Committee and I am pleased to welcome him back today.

John, we would be happy to hear from you.

STATEMENT OF JOHN COURSON
CHAIRMAN–ELECT, MORTGAGE BANKERS ASSOCIATION
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CENTRAL PACIFIC MORTGAGE COMPANY
FOLSOM, CALIFORNIA

Mr. COURSON. Thank you, Mr. Chairman. It is good to see you again. And thank you on behalf of the Mortgage Bankers for the opportunity to testify again and present our views as you continue your series of hearings on the aspects of predatory lending. I would like to just briefly summarize some comments, if I may. I am going to really talk about three things—tools, rules, and disclosures.

As you so eloquently said in your opening statement before that, used properly, yield spread premiums can be an important financing option. And we agree with that. It clearly is a borrower choice issue when used properly, based upon a borrower's individual financial goals, desires, and circumstances, in that, as they make those choices, there has been a wide use of yield spread premiums.

We find people in the industry of all types of loans, as we have identified, be they conventional, be they FHA, VA, that take advantage of the opportunities to have a financial choice in how they want to use this tool to acquire their property or refinance their mortgage loan.

It can be, and we know that one of the barriers to creating homeownership is certainly the availability of cash resources. And so it does provide an option for those who do lack the cash to finance or, if you will, to pay the cash cost of obtaining that mortgage, another alternative to achieve homeownership when used properly.

As to the rules, we need rules in the lending business and the broker business to run our businesses. Tell us the rules so that we can conduct our business in accordance with the rules, and not have to learn the rules through the courts and through litigation, which is debilitating not only for us, but also for consumers and could in fact do damage to the marketplace.

Tell us the rules and give us clarity. Give us some clarity where we can understand what the parameters are under which we can conduct our business appropriately—whether it is mortgage brokers or mortgage lenders.

The Statement of Policy, both the 1999 and now the 2001, is a move by the Department to provide clarity for those in the mortgage origination business to conduct their business.

As for disclosure, as you well know, Mr. Chairman, and we discussed in the last hearing, there are disclosures out there today that are structured to address some of the issues we have heard.

We know, for example, that yield spread premiums are to be disclosed on a good faith estimate. We clearly know the issues with the good faith estimate as we have discussed before. We also know that yield spread premiums are to be included in calculation of the APR, which is a number that a consumer has to comparison shop, if you will.

We also know, obviously, that they are on the HUD–1, which we have heard about. But having said that, in the 2001 Statement of Policy, the Department clearly sets out, both in the Statement of Policy and in a mortgagee letter that was issued very shortly after the Statement of Policy, some clear guidelines for the disclosure of broker transactions and they set forth very specific criteria to be included in those disclosures.

As a result of that information, the Mortgage Bankers Association, along with a coalition of other lending organizations, have prepared and did prepare a prototype, if you will, of a disclosure. And that disclosure is formatted to address the specific criteria that are included in the Statement of Policy and in the mortgagee letter. I would be happy to submit a copy of that draft, which we have submitted to HUD for their consideration for the record, if I may. And finally, having said all of this, and despite the comments and the specificity and the Statement of Policy, and in the mortgagee letter and our draft proposed form, we really can do better.

Beyond all of this, one of the keys, regardless of the kind of disclosure we use in this specific instance, we have to simplify the transaction. We can do better than what we have done for the consumers out there with the myriad of paperwork and disclosures, small print, and confusing information given to them. Any predator likes that environment to deal in. It makes it easier to operate. We need to strip that out, strip the process down, simplify, and reform the mortgage process.

Thank you very much.

Chairman SARBANES. Well, thank you very much.

We will now turn to Joseph Falk, President of the National Association of Mortgage Brokers. Mr. Falk served as the President of the Florida Association of Mortgage Brokers in the mid-1990's. In addition to his activities with the National Association of Mortgage Brokers, Mr. Falk serves on the Fannie Mae National Advisory Council. He is currently President of Erie Mortgage Services, a mortgage brokerage business specializing in residential mortgage loans, regulatory compliance, and government affairs.

Mr. Falk, we appreciate your coming to be with us this morning. We would be happy to hear from you.

STATEMENT OF JOSEPH L. FALK, PRESIDENT NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. FALK. Good morning, Mr. Chairman.

My name is Joseph Falk and I am President of the National Association of Mortgage Brokers, the Nation's largest organization representing the interests of the mortgage brokerage industry. We appreciate this opportunity to be with you today.

Mortgage brokers originate approximately 65 percent of all of the residential loans in the United States. There are hundreds of thousands of mortgage brokers, 23,000 licensed brokers in my home State of Florida.

The market has spoken. Mortgage brokers are effectively meeting consumers' desires for convenience, choice, products, service, and very competitive prices. The industry originated a record volume of loans in 2001, enabling thousands of homeowners to refinance, reduce their monthly payments, and thousands of others to get in their homes.

We are experiencing record homeownership rates in the United States today. Mortgage brokers in part have enabled this market to absorb this huge volume of transactions. Therefore, it is important to our homeowners and the economy that we avoid any new regulations, legislation, or unnecessary legal uncertainty that could impede the effective and efficient functioning of the wholesale mortgage market.

The ability to obtain loans with little or no upfront cost is especially critical to consumers. Borrowers can finance some or all of their upfront costs through a slightly higher interest rate and the broker receives most or all of its compensation indirectly from the lender in the form of a yield spread premium. Such indirect compensation paid by lenders to brokers is legal under RESPA, so long as the broker's total compensation is reasonably related to the services performed, goods provided, and facilities furnished.

Flexibility of indirect compensation allows mortgage brokers to stay competitive with and in some cases beat the prices of retail lenders. That is why the marketplace has spoken. Mortgage brokers are chosen, by and large, because they offer competitive prices to retail lenders.

Retail lenders perform similar functions, earn similar income when they sell their loans in the secondary market. There is nothing inherently different about the way retail lenders and mortgage brokers earn their income. The only difference is that consumers know how much a mortgage broker is going to earn in a transaction because it is listed on the HUD–1 and, of course, on the Good Faith Estimate form.

Although consumers clearly prefer mortgage brokers to originate their loans, our industry is under attack. Over 150 class action suits have been filed against virtually every major mortgage wholesaler claiming that all yield spread premiums are illegal. Defending these suits, Mr. Chairman, is difficult and managing the uncertainty that they impose is costly.

On October 15, HUD issued policy statement 2001–1. We believe it is simply a restatement of existing policy requested by Congress in 1998 and originally issued in 1999. It has already been accepted as correct by two court rulings and we believe that others will follow suit. HUD's policy statement importantly maintains the individual's right to sue and it allows the marketplace to resume functioning normally. We support the HUD policy statement.

We also support HUD's new RESPA enforcement policy. Illegal uses of yield spread premiums should be prosecuted to the fullest extent of the law.

NAMB also supports HUD's new rulemaking initiative which improves disclosures to consumers. Better disclosures will put consumers in a stronger position with more information to be able to shop and compare, thereby decreasing the incidence of abusive lending practices of all types.

NAMB has developed detailed proposals for this rulemaking and we have shared these with HUD and with this Committee. We support requiring a new disclosure to be provided by all originators. We developed the prototype of this form back in 1998, together with MBA, and we have urged our members to use this form since 1998, clearing up a number of the concerns that we heard this morning. We support making this disclosure mandatory.

We also support establishing tolerances for the Good Faith Estimates and requiring redisclosure if those tolerances are exceeded. This would also address the concerns we heard, the legitimate concerns we heard this morning in the first panel.

In conclusion, Mr. Chairman, NAMB believes that HUD is acting responsibly by clarifying the legality of yield spread premiums, improving RESPA enforcement, and developing new and improved disclosures that will help consumers avoid abusive fees.

Thank you for this opportunity to allow us to share our views with this Committee. I would be happy to answer your questions.

Chairman SARBANES. Thank you very much, sir. We appreciate your contribution.

Our next witness is Ira Rheingold, who is the Executive Director of the National Association of Consumer Advocates. Previously, Mr. Rheingold worked at the Legal Assistance Foundation of Chicago as a Supervisory Attorney in charge of foreclosure prevention.

The major focus of his litigation practice was the representation of senior and disabled homeowners victimized by mortgage brokers, lenders, and contractors who were targeting minority, low-income communities with high interest, high fee home equity loans.

Prior to becoming a Legal Services Attorney, Mr. Rheingold worked as a Legislative Advocate for low-income community groups in southern Maryland. He is a graduate of Georgetown University Law Center.

Mr. Rheingold, we are pleased to have you with us this morning.

STATEMENT OF IRA RHEINGOLD, EXECUTIVE DIRECTOR NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

Mr. RHEINGOLD. Thank you, Senator Sarbanes, it is my pleasure. And thank you so much for inviting us here to testify today.

I had prepared remarks and I have submitted testimony which fully express our position in this matter. But instead of talking about what I was going to say, I am simply going to respond to some of the testimony I have heard today because sometimes as I sit here, I think I live in a parallel universe, that there are two universes—the people who deal with people on a real basis every single day, who see homeowners every single day, and then the theoretical universe out there about how the system is supposed to work. And we just do not see it.

I was an attorney who represented homeowners for 5 years in the poorest communities of Chicago. I looked at loan document after loan document after loan document. What I heard here testified to today and what Professor Jackson said today was wonderful because it quantified what we saw and we know is true. It is not atypical.

I never ever talked to a client who knew they had paid a yield spread premium. In fact, I never met a client who, until I sat down with them, showed them their HUD–1, and said, hey, did you look at this line over here? You are being charged $1,500. Did you know that? And they said, no. And I said to them, did you know that because that yield spread premium was paid, you had a higher interest rate? And they said, absolutely not.

Nobody knows what is going on. You can give all the disclosures in the world—and there are disclosures. We look at the loan documents and there may be a disclosure about a yield spread premium being paid. It is not happening and it has no bearing on what consumers are seeing today. Point number one.

Point number two I would like to address is the mortgage industry and their claim that there has not been clarity about this issue. I think that is particularly cynical when we look back at what HUD offered to us in 1999, when they issued their first Statement of Policy. I am just going to quote some of the language from this Statement of Policy, giving explicit directions to lenders. And this is in our testimony, but I think it is worth repeating.

> The most effective approach to disclosure would allow a prospective borrower to properly evaluate the nature of the services and all costs for a broker transaction, and to agree to such services and costs before applying for a loan. Under such an approach, the broker would make the borrower aware of the total compensation to be paid to the mortgage broker, including the amounts of each of the fees making up that compensation. If indirect fees are paid, the consumer would be made aware of the amount of these fees and their relationship to direct fees and an increased interest rate.

I do not think it could be any more explicit than that. I think it was clear how the industry could comply with what HUD was going to do. But did the industry comply? They did not comply.

Why didn't they comply? Because they were making a lot of money. They were making a lot of money continuing this practice and there was no enforcement going on that would stop them from engaging in this practice. So instead of changing their practices, engaging in behavior that would be legal, would be fair to the consumer, and creating a competitive marketplace, instead what they did was they spent all their money fighting lawsuits and obfuscating the policy statement and going into court and saying, dealing with small lawsuits like me, I would go to court and I would represent an individual homeowner and I would come in and I was a little gnat. We were little gnats. Here is a couple thousand dollars. Go away. We will not foreclose on this person's home. It was the cost of doing business. But it was a small cost of doing business because they were making enormous profits.

The world changed for the mortgage industry when the 11th Circuit Court issued the Culpepper decision because, finally, a court found their hand, their arm, their elbow in the cookie jar. They said, look, this is so obvious.

The thing that I find so interesting about this issue is it really is very, very simple. The court looked at it and said, in practice, the lender sends a mortgage broker a rate sheet and it says to the broker, if you bring me a loan—here's the par rate that the person qualifies for. If you bring me a loan higher than that, I am going to pay you this amount of money.

Nowhere in that discussion is, if you bring me a higher interest rate and perform more services, I am going to pay more money. The sole source of whether or not the broker is getting compensated is what the interest rate is going to be. No one was looking at whether or not there were more services being offered because someone was getting a higher interest rate. The sole reason for compensation was the higher interest rate.

The court said, what else do I need to know? And that enabled a class to be certified. The industry got scared. They got scared because, suddenly, the behavior that they had been engaged in, that they had measured the cost of and figured this is not going to cost us a lot of money, we are making so much profit, was now threatened because it was a class action case, which is an important enforcement mechanism we have in this country because there is no other source of enforcement going on. It will cost us real money and we will have to stop our behavior.

But, again, did the industry stop its behavior? No, they turned to HUD and they gave HUD an opinion. We met with HUD and the industry met with HUD. And HUD, instead of coming down on the side of consumers and saying, hey, your behavior is wrong, stop it, let the Culpepper case go on. HUD came to the rescue, adopted a clarification, changed the way and gave protection to the industry. It said, no class actions allowed. It has to be done on an individual basis. And that is so important because individual cases cost the industry nothing. They are little gnats. A class action case makes them change their behavior. They do not want to change their behavior, and that is what is happened here.

I will take questions later on about policy suggestions that we have made. We agree wholeheartedly with Professor Jackson's suggestions, but I just wanted to make those points right now.

Chairman SARBANES. Good. Thank you very much.

We will now turn to David Olson, Managing Director of Wholesale Access Mortgage Research and Consulting, an independent research firm located nearby in Columbia, Maryland, that specializes in the mortgage industry. Mr. Olson has had over 30 years' experience in the mortgage industry conducting research for a variety of firms. He has served as Professor of Economics at the University of Michigan, Smith College, Johns Hopkins University, and the University of Maryland. He holds a BS degree from Northwestern University and a master's in economics from the University of Michigan.

Mr. Olson, we are very pleased to have you with us this morning.

STATEMENT OF DAVID OLSON, MANAGING DIRECTOR WHOLESALE ACCESS MORTGAGE RESEARCH AND CONSULTING, INC.

Mr. OLSON. Thank you very much, Senator Sarbanes, for inviting me and I am pleased to be here with a fellow Marylander.

There has been a lot of assertions made today. I thought I would respond as others have done to some of the assertions. I have submitted a printed statement of my formal remarks.

There are a lot of statements being made about how profitable brokers are and how profitable lenders are. My research has been partly in profitability. That is all our firm does. We have seven professionals. We have been studying various aspects of the mortgage industry and particularly brokers and lenders for over 10 years and, as I say, I used to be Director of Research at Freddie Mac and several other firms. I have been researching many aspects of this industry for over 30 years. I started in 1969 with my first research project. So, I have looked at a lot of these questions and I have a lot of data. We have real data. One of the first points I will make, it is not very profitable. And if it were so profitable, why are we seeing a net exodus out of many areas of the field? There are firms pulling out because they cannot make profit.

My initial research was, and in the Soviet bloc countries, I did 10 years of work in that area, and I saw first-hand, I spent time in the Soviet bloc and I saw what happens when you have over-government regulation, government in effect running everything, and it is a disaster. Consumers really lose out.

Today, we have heard some abuses. I am not denying abuses. But we have to put it into context of the numbers. Last year, we estimate there were 16 million transactions. What was a representative transaction? Our research is mainly based on random samples. And just the last study we did on brokers, we interviewed 4,000 broker firms to find out what is actually going on there. How representative is this? Is there a lot of abuse? We would assert that there is not. And the reason that brokers came from nothing 20 years is that in fact they can do it cheaper. They have priced everyone else out of business.

There are 8,000 lenders out there. Any consumer can always go into one of these 8,000 lenders and get a quote. What would it cost me to do this loan?

There are really two numbers that a consumer needs—interest rate and fees, what are the total fees? Everything else is really irrelevant. The other, of course, is will you do the loan, period? And that has been one of the problems in the industry. It is such a huge industry. There were $2 trillion of loans done. Just to get a loan done is very difficult in certain periods, such as last year.

So, consumers have sought out brokers merely to get a loan. We have not looked at the alternative of no loan. What if the consumer got nothing? We were saying that it was high and then we are assuming that they could have gotten a better deal elsewhere.

Well, why didn't they price it elsewhere? We have 33,000 mortgage broker firms, according to our records right now, plus the 8,000 lenders. It is very easy to get a quote, find out what it costs to do a loan.

Now, whether they will do your loan is the issue. Can they do your loan for this price? Was it cheaper or more expensive? We would always advise everyone, any consumer, to shop around and go get quotes. And our experience is that most consumers do get multiple quotes and make it difficult for brokers.

Most brokers are just breaking even. If this were so profitable, we would have found that brokers would be staying in this industry. But in fact, the average firm lasts only 5 years and then they are out because they go elsewhere. They find that they can do better elsewhere. It is not that profitable an industry. There has been this implication of how profitable it is.

The same with mortgage lending. That field is not that profitable. And if it were not the case, we would not see this net exodus. Now, I will agree that there have been abuses in so-called subprime lending and I think that is what we have been really hearing. I can defend it from several reasons.

We do not have enough lenders offering these loans. The less the competition, the more you will tend to find higher prices. What we need is really more competition, more people offering these loans. But what I have noticed—I publish a quarterly magazine on this issue. There has been a huge exodus out of subprime lending. Most of the major lenders that were in operation 3 years ago have shut down. They have been generating losses. They are still generating losses.

If this is so profitable, why are they all generating losses? Why are we still seeing a net exodus? And so, I would assert that, unless we do something else, if you kick all the business out of the industry, who is going to be left to make these loans, and where will the consumer go?

There has to be a real, live alternative for the consumer. We have been talking about abstract alternatives. We have to say, who offered you what? Could you have gotten something better? Then, the other cases, were these instances representative of the whole?

From my point of view, we have great regulation, probably too much regulation. I would agree with some of the other witnesses that it is extremely complicated. And it is because it is so complicated that brokers have to do their job. Just to go through all of those sheets of paper and get them right, it costs about 2 points, 2 percent to do this job.

Government has an opportunity to make it simpler. If it were so simple, it could be all done on the Internet for a fraction of that cost. I think that we would be better served by making it simpler and then this job of leading people through all this paperwork would not be necessary and it would be more transparent and it would be easier for everyone to understand and focus on what is the most important thing?

We want the person in the house. We want a low interest rate and we want low points. That is the objective. Who can do the best job of getting us there? What is the best way?

From my perspective as an independent observer, the best way is to get it as simple as possible, not put on another layer of regulations, and certainly not try to assault the industry through class actions. Our data shows that a typical class action lawsuit costs the lender $1 million per suit, and there are 150 suits. So that would add up to about $150 million. That cost is picked up by the lender and then passed to the consumer. The lender does not operate for nothing. It is a huge cost, a huge tax that has been added on to the industry and is certainly unnecessary and incorrect.

I would be happy to work with you in any way I can in my professional capacity, and thank you for inviting me today.

Chairman SARBANES. Thank you, sir.

Our final witness this morning is David R. Donaldson, from the law firm of Donaldson & Guin, LLC.

Mr. Donaldson has practiced law for over 20 years and has extensive experience in consumer protection and real estate litigation cases. He is a lecturer on topics related to lender liability under the Real Estate Settlement Procedures Act, a 1975 graduate from the University of Alabama at Birmingham, and a Dean's Scholarship to the Cumberland School of Law, where he was an Associate Editor of the *Cumberland Law Review.*

Mr. Donaldson, we are pleased to have you with us this morning. We would be happy to hear from you.

STATEMENT OF DAVID R. DONALDSON, COUNSEL DONALDSON & GUIN, LLC

Mr. DONALDSON. Thank you, Chairman Sarbanes, and thank you for inviting me.

I am one of the plaintiff's counsel in the Culpepper case, which you have heard so much about here today. That litigation and the U.S. Court of Appeals opinion in that case—and there are three of those opinions—are based on a very simple proposition. That simple proposition is that mortgage brokers should not charge borrowers more than the broker agrees to accept for his or her services. I do not believe that that is a controversial proposition.

Yet, for some reason, when the Eleventh Circuit Court of Appeals issued an opinion that said, this yield spread premium was not a payment for services because nothing else was owed for those services, it caused the industry to go into an uproar. And that first decision was issued in 1998. That message was sent a long time ago.

The mortgage industry, rather than amending and changing their practices, believed that they could continue violating the law simply by avoiding class certification decisions in that class action and in other class actions.

I was interested to read when I read the prepared statement of Mr. Courson, he describes the operation of the yield spread premium in this way. He says, "as the interest rate goes up, the borrower's upfront cash contribution goes down." He then goes on to say, "I want to clarify, unequivocally, that the yield spread premium mechanism should be restricted to the function I just described."

I understood what he said, and if I am misunderstanding it, he is here today and he can correct me. But as I understood it, he is arguing the same thing I have been arguing for the last 5 years to the mortgage industry, which has turned a deaf ear.

Under the Culpepper rule that was established by the appellate court, the only thing that a lender has to do to avoid a class action lawsuit on yield spread premiums is to put language in the lender's contract—and they all have standard-form contracts that they use with their brokers.

If the lenders would simply put this same language in their contracts—that is, we will pay yield spread premiums on over-par loans where they are used to lower borrower's upfront costs. And if they would actually enforce that, and it is easy to see whether a yield spread premium is used to lower upfront costs because there is a line for it on the HUD–1.

If that were done, and I and other plaintiff's lawyers have been advocating that now for 5 long years—if that had been done 5 years ago, the industry would not be facing the problems it is facing now. And if it were done tomorrow, it would not be facing yield spread premium litigation under Section 8 of RESPA the next day.

The industry claims, and I wrote this quote down this morning, so I may not have gotten it verbatim, but it is close—tell us the rules so we can conduct business. That is what the industry says it wants. If that is what the industry wants, I cannot understand why it went to HUD and demanded HUD promulgate a rule that says a yield spread premium is legal, so long as it is reasonable.

Mr. Falk claims that the RESPA statute says that yield spread premiums are legal, so long as the total compensation is reasonable. But the word reasonable is not contained, Chairman Sarbanes, in that statute. In preparation for coming to talk to you today, I went back and reread the Senate report issued by this Committee's report in connection with that 1974 piece of legislation.

HUD asked the Congress for authority to determine what was a reasonable price for settlement charges and Congress refused to grant HUD that power. In this Committee's report, it stated several reasons why that was a bad idea. And one of the reasons stated was that it would require an army of bureaucrats to look at the transactions to determine what is reasonable.

I also heard this morning Mr. Olson say that there are 16 million transactions. The printed testimony from the Mortgage Brokers Association says that brokers are responsible for roughly two-thirds of those. So that would be something in excess of 10 million transactions. I would submit to you that it does not make any sense for HUD to attempt to examine 10 million transactions to determine whether a payment is reasonable, whatever that is.

Apparently, the truth of the matter is, the reasonableness standard, which is not the law and should not be the law, is simply a way to legalize any kind of illegal practice so long as it is widespread. As long as all of the brokers are getting the payments, it becomes reasonable and, under that standard, legal. Anything would be legal under that standard.

Chairman SARBANES. Virtually anything, yes. I guess the extreme, the very egregious might fall outside of the parameter. But otherwise, they just make reference to what the rest of the industry is doing and say, well, this constitutes a reasonable practice. Is that the point?

Mr. DONALDSON. Yes, sir.

Chairman SARBANES. Yes.

Mr. DONALDSON. Beatrice Hiers, who everyone heard from this morning, is one of the plaintiffs in the Culpepper case. And the defendant has argued long and hard that she received the benefit of that yield spread premium and that it was reasonable. That position was taken.

The 2001 policy statement purports to treat yield spread premium payments to brokers in a totally different manner than it treats all other up charges. The example that is given in the policy statement is a situation where a lender obtains an appraisal for $175, charges the borrower $200, and pockets the $25.

Now, the 2001 policy statement says that that is a violation of Section 8 of RESPA. While I do not disagree with that, I suspect that if I were to bring a lawsuit under that same fact situation, the response would be, look, from the defendants, $200 is a reasonable cost for an appraisal, and in fact, it may be a reasonable cost for an appraisal because a lender that purchases thousands of appraisals a year can probably force the appraiser to drive the price down.

It may be a reasonable cost. But HUD is saying that is illegal. Yet, if a broker and borrower agree for a 1 percent loan origination fee, and if no other compensation is agreed upon, and at the closing table, the broker receives double that amount, in HUD's view, that apparently is perfectly legal.

There is no legal distinction between those two situations based under the same statute and there is certainly no intellectual distinction that I can understand.

In closing, I would like to respond very briefly to the statement about class actions that was just made by Mr. Olson. The man sitting at the end of the table is a Harvard Professor who prepared a study. It was not done at my request, but it was done at the request of other plaintiffs' class action lawyers in another RESPA case. We would not have that kind of information today if we had to rely—that was done because a class action lawyer has a lawsuit and it is a very expensive study because it took a lot of intelligent people a lot of hours to do it.

Lawyers are not going to spend that kind of money to prepare those kinds of studies in order to get back $1,000 for somebody. It does not make economic sense.

The idea that when litigation expenses are incurred, that it drives up the cost, defies what I understand to be simple economics, which is that retail prices are a function of supply and demand. I do not see how suing 150 out of the 2,800 lenders causes the price of mortgages to go up, and I do not think it does. I think that is a red herring.

Last but not least, I have not conducted a study like Professor Jackson, but I have talked to a lot of borrowers. And it is my clear impression from those conversations that supports what he found about discrimination in yield spread premiums.

The Wharton study that you referred to at the beginning of your comments here today, was not done for plaintiffs' lawyers. It was done by a professor who is featured prominently on the Mortgage Bankers Association's own web site. That study found that the two determining factors for how much mortgage brokers get paid are the size of the loan and the sophistication of the borrower.

Thank you very much, Chairman Sarbanes.

Chairman SARBANES. Well, thank you.

I want to thank all six panelists for their contribution. This was a panel that embraced a number of varying viewpoints and of course, it was our objective to get kind of a broad presentation. So, I want to thank all of you for coming today, for preparing what are obviously some very thoughtful statements, all of which will be included in the record in full.

Now let me turn to a few of the issues that I think have emerged here. First of all, I want to address this question of the class action suits as opposed to individual suits because the new HUD directive is read to preclude the class action suit, as I understand it, or it is being so interpreted by some courts already across the country, if I am not mistaken, the 2001 statement.

Although it is then asserted, these individual suits can be brought. I think everyone has conceded that the individual suits can be brought. But it seems to me that what is going to happen is that any recourse to the courts to remedy the situation is going to be closed out because the amount of recovery in an individual case is so small, that you are not going to be able to mount the legal effort that is necessary to bring these practices under control.

Now the counter to that is, well, if we allow the class action suits to go ahead, they will recover huge amounts and that will impose a very significant burden on the industry. Let me ask you, Mr. Donaldson, the individual's suit really does not provide much recourse to the courts, does it, to get at these practices?

Mr. DONALDSON. Well, it does not change the practices. When the Circuit Court of Appeals issued its first opinion in January 1998, the industry's response was, so long as the plaintiffs cannot get classes certified, we can go on our merry way and not change our practices. They said that publicly in the press.

So, I think that answers that question. And you are certainly correct. It is difficult to undertake litigation and fight for long years, as we have in this case. It has been going on for 5 years, even a large yield spread premium is a small amount of money to fight over for years and years.

Chairman SARBANES. Now what is the requirement that you say, if the industry followed it, would in effect eliminate the abuse of these practices?

Mr. DONALDSON. I did not really say what I thought might eliminate the abuse of the practices, and I am not sure, as far as if you want my opinion on that question, certainly Secretary Martinez's suggestions in his mortgagee letter that has been discussed here today would be a good step in the right direction.

Chairman SARBANES. The Department is arguing that what they have done is protective of the consumer. And I am having great difficulty understanding why that is the case.

The industry went to them to get protection from the class action suits. The class action suits would be a very heavy discipline on the industry if they carried forward, proceeding from Culpepper. So there was a discipline mechanism in place to, in effect, compel the industry presumably to clean up these practices. Otherwise, they were going to pay significant penalties, or recompense.

It is not clear to me, if you take that out, what is left, or where you will turn, then, to protect the consumer from these practices. And so, despite the Department's assertion that this is to help the consumer, I have difficulty in following that, one of the reasons we are doing this hearing here today.

Mr. Jackson, let me turn to you because you have done some very careful studies and I would be interested in your response to that question.

Mr. JACKSON. Well, I think that the policy statement can be interpreted as a significant impediment to litigation. As I mentioned in my testimony, I think the Department misunderstood the role of yield spread premiums at least for a large number of mortgage lenders. And so, it is possible that, on different facts, courts would proceed differently with the policy statement. So it is still possible to maintain litigation, I hope, against certain lenders.

I would say that the management of class actions is a function for the courts to decide. I think the courts are responsible for determining how to structure their cases. And HUD does not have expertise in class action management, so the court should take a look at these cases and see what the sensible way to proceed is.

That having been said, I think that the Department must go further on disclosure. The current disclosure techniques are simply inadequate. The main problem is the yield spread premiums, when they are disclosed, are disclosed as payments from the lender to the broker. A consumer would reasonably think it has nothing to do with them. And in fact, if you go on the HUD's web page today and look for an explanation, HUD says these payments have no cost to you. It is quite misleading for consumers and I am quite sympathetic to people——

Chairman SARBANES. Well, they have a cost to the consumer in that they are paying a higher interest rate, don't they?

Mr. JACKSON. I absolutely agree which is why I think the current HUD instructions and glossaries that are on their web page are just quite misleading.

Chairman SARBANES. Now, Mr. Courson, I understand, is it your position that if there is a yield spread premium, it should go to the credit of the borrower?

Mr. COURSON. Let me explain my statement in that regard. Once the broker establishes what their compensation is going to be in a transaction, as they enter into this transaction with the consumer, whether at that point that compensation is agreed upon is either paid in cash or paid through the use of the yield spread premium, should be the same dollar figure.

In other words, you establish the compensation for which you are going to provide the services and then, giving the consumer some choices, which I talked about in my opening statement, as to whether to pay that compensation in cash, pay it through a higher interest rate in a yield spread, or through a combination of both. It could be both.

Chairman SARBANES. You think that the consumer should know up front what the broker's charges will be?

Mr. COURSON. Yes.

Chairman SARBANES. Do you agree with that, Mr. Falk?

Mr. FALK. We believe that the compensation should be included on the Good Faith Estimate, together with the rest of the costs of the loan, so that consumers can adequately shop and compare between different financing options. Yes, they have to be disclosed, together with all of the other costs on the Good Faith Estimate.

Chairman SARBANES. So would you have the broker's recompense separately disclosed to the consumer up front?

Mr. FALK. It is currently separately disclosed on the Good Faith Estimate. Yes, it should be itemized under the current system.

Chairman SARBANES. How would you handle the yield spread premium issue?

Mr. FALK. As a separate disclosure on the Good Faith Estimate, which is current law.

Chairman SARBANES. Mr. Jackson.

Mr. JACKSON. I just disagree. I think that this is the kind of misleading statement.

Chairman SARBANES. Yes, let us talk about that.

Mr. JACKSON. It is currently disclosed as a POC—paid outside of closing—from lender to the broker.

Chairman SARBANES. Right.

Mr. JACKSON. It is absolutely unclear under current law that the borrower is paying that through higher interest rates.

Chairman SARBANES. Would you make it clear to the borrower, Mr. Falk, that the borrower is paying it?

Mr. FALK. I would make it clear that all compensation is clear and concise.

Chairman SARBANES. Let me just deal with that very specific thing that Professor Jackson referred to.

Mr. FALK. Yes.

Chairman SARBANES. Would you make that clear to the borrower, specifically?

Mr. FALK. Broker fees are in part, fees paid by the lender for goods, services, and facilities provided to the lender by the broker, and partially fees for goods and services provided to the borrower. It is a combination of both. Therefore, that is why we believe that the initial disclosure form, the model loan origination agreement "souped up," as we recommend to HUD, should be clearer on the definition of these various fees and charges.

Chairman SARBANES. Mr. Courson, would you make it clear, by responding to Professor Jackson?

Mr. COURSON. Mr. Chairman, yes. I submitted for the record and I have shared with the Committee a prototype, as I described it, of a disclosure agreement that we think incorporates what Mr. Donaldson discussed, and Mr. Jackson discussed, as part of the statement of policy in the mortgagee letter. And the thrust of this agreement, if you will, entered into at the start of the application process discloses the total broker compensation.

So, in that regard, it would include whether it was compensation to be received through a yield spread, whether it was compensation to be received through an origination fee. It would be the total compensation from whatever source. And then I think as you look through that prototype agreement that our coalition put together, then it offers the consumer some choices.

It says to the consumer that here is the compensation. The compensation will not exceed X and you have some choices. And then it goes through some choices as to paying in cash, paying through a higher interest rate, paying through a combination and so on. So that captures all elements of that compensation into a number on a not-too-exceed number, and then gives the consumer the opportunities I talked about in my statement of options on how to deal with those costs.

Chairman SARBANES. It seems to me that one of the difficulties here is the way the system is working now, and this goes to Mr. Rheingold's point about it is one thing to talk about it in theory. It is another thing to see how it works in practice, is that you have an option which you say, if properly used, enables the consumer to have an additional financing approach. Namely, a higher interest rate and then they get some money with which they can cover their closing costs. So, they do not need as much money up front. And that sounds like a worthy objective. But in practice, since it is not disclosed or disclosed in such a way that it is not apparent that this option is available, in effect, it becomes a rip-off of the consumer. It becomes an abuse.

Now that raises the question, and this goes to how widespread the practice is, which goes back to Professor Jackson's study, but that raises the question, if there is substantial abuse, whether it is worth having this option available, if the consequence of having it available is to get the kind of instances that we heard from from the first panel this morning. Now that approach, in a sense, would close out an option that people say, if properly done, is desirable. On the other hand, if we cannot figure out a way to close out the abuses and sustain the option, and if the abuses are fairly prevalent, that may be the only recourse.

Mr. Rheingold, you wanted to comment.

Mr. RHEINGOLD. Yes. Although I have not read Mr. Courson's disclosure of the model that he talks about, I can say that the concepts he expressed, we would fully endorse. We do not oppose yield spread premiums and we think, as you said, they actually can work in a manner that would benefit consumers.

The point being here that if there is a total compensation disclosed up front, this is what I am going to get paid. I am your broker. This is what I am going to get paid. If the consumer is given a choice as to the method of payment, that is fine.

The system that we have here today is market-distorting. One would think that if you have a broker, the broker will shop for you so that you get the best available loan. In essence, what we have here, in practice, as demonstrated by Mr. Jackson's study, is that the broker is not finding you the best available loan for your benefit, but they are looking for loans where they will get paid more money.

In essence, the marketplace is not functioning right now. And if you, in fact, have a scheme where the total compensation is laid out upfront, and whether or not a yield spread premium is paid or not, I am going to pay that broker $2,000. I may pay it in cash.

I may get it refinanced. I may have the lender pay that $2,000. I will choose it.

But that money is set in stone and then there is no incentive for the broker to find a higher interest rate for that person because their compensation is not going to change based on what the interest rate is.

Chairman SARBANES. Because they will not get the yield spread premium.

Mr. RHEINGOLD. Well, they will get the yield spread premium.

Chairman SARBANES. But it will be credited to the borrower.

Mr. RHEINGOLD. Right. It will be a way they get paid, but there will not be an added incentive to find a higher interest rate because they will get paid more. That will eliminate it and the scheme that Mr. Courson describes, I believe will actually eliminate that market-distorting incentive that currently exists.

Chairman SARBANES. Mr. Falk, what do you say about that?

Mr. FALK. Well, I think the marketplace is working for a vast number of Americans who have refinanced this year and saved billions of dollars of interest expenses.

Mortgage companies act in multiple capacities, Mr. Chairman. Sometimes a mortgage company acts as a lender in a transaction and sometimes the company acts as a broker in a particular transaction. So, however you define the transaction, total compensation should be disclosed fully. It should be as transparent as possible. And it should meet with the wishes and the guidelines and the desires of the consumer.

Therefore, I believe the market is working. We have increased competition, which is what we want in the marketplace. And I believe, by and large, mortgage brokers are bringing reduced costs to the marketplace and doing an excellent job.

Chairman SARBANES. How do I know which broker to go to on a competitive basis if they are not disclosing to me up front what their charges are?

You say it is working on a competitive basis and I am then led to wonder, well, a lawyer will tell me what his fee is, a stockbroker tells me what his commission is, a real estate agent tells me what their fee is. If I cannot get that specific information from the broker, how do I shop amongst brokers as to who is going to give me the best value.

Mr. FALK. We believe that consumers should always shop and compare, not only between brokers, but also with retail lenders, banks, credit unions and savings and loans. We are all part of that system.

Chairman SARBANES. Well, that is Professor Jackson's point, and we may get to that. I mean, we are dealing with a broker problem now and I can understand the brokers saying, well, if you are going to deal with the broker problem, we want you to deal with any comparable problem that may exist with the lenders. And that is broadening the universe of what we have to deal with. But let us for the moment operate with this limited universe we are addressing. How do we ensure that we will not get the kind of practices that we heard this morning from the people on the first panel?

Let me ask this question first. Is there anyone on this panel who, having heard what we heard from the first panel, says, well, this is how the system operates and we get other benefits out of the workings of the system and therefore, we do not really think anything should be done to close out the practices that we heard this morning? Is there anyone at the table who takes that position?

Mr. Olson.

Mr. OLSON. I think that those are exceptional circumstances.

Chairman SARBANES. Pardon.

Mr. OLSON. I think they were exceptional circumstances and not typical.

Chairman SARBANES. Let me not argue whether they are exceptional or not for the moment. Let me just get a response, whether there is anyone on this panel who thinks, having heard those practices, who says, well, it is regrettable, but we have this system that works, or we have this system in place and it moves a lot of transactions and people get credit and all the rest of it, and therefore, we really cannot close out those practices and we just have to, in a sense, accept them or tolerate them. And then, presumably, one would argue that there are not very many of them, and others would argue that there are quite a few of them. But is there anyone who thinks we just should accept those practices, at the table?

Mr. OLSON. I think we have been given some alternatives. If we make the compensation up front, then there would be less of this practice. I would agree with that.

There is always imperfections in any market and I do not know if you can always eliminate every problem. We could go to shopping for a dress or going to the restaurant. There is always cases where someone paid more than they wish they had.

Chairman SARBANES. No, no, this is not a case where they pay more than they wish they had. This, it seems to me, what we heard this morning are cases in which they were clearly taken advantage of. They placed their confidence in someone. They, in effect, got representations that the person was really working on their interests, and it turned out they were not working in their interests and they put them into very difficult situations.

Now, Professor Jackson says on the basis of his study, that he thinks that such practices are fairly widespread. Am I interpreting that correctly?

Mr. JACKSON. That is correct. It is much more widespread than several panelists this morning would suggest.

Chairman SARBANES. Yes.

Mr. JACKSON. It is a very generic practice and problem in the industry.

Mr. DONALDSON. Mr. Chairman, could I respond to the statement about the frequency of these occurrences?

Chairman SARBANES. Sure.

Mr. DONALDSON. With all due respect to Mr. Olson, Ms. Hiers got a mortgage from Irwin Mortgage Corporation, the defendant in the Culpepper case. I and other plaintiffs' lawyers who are representing that class have looked through approximately 5,000 loan files. I did not find and, to the best of my knowledge, no other person found a single situation where any borrower was saved one thin dime in closing costs as a result of a yield spread premium being paid. And the idea that these are not commonplace problems simply cannot be—that allegation does not withstand the light of day of scrutiny if you actually look at the loan files.

Situations like Beatrice Hiers' are not the least bit uncommon if you go look through these defendants' loan files. And although the mortgage bankers and the mortgage brokers are sitting before this Committee here today talking about how willing they are to disclose, my reading of the *Federal Register* of the negotiated rulemaking with HUD over the last several years, starting in 1995, tells me that they have vociferously fought against any disclosure whatsoever.

And in preparing to come here today, I went to NAMB's web site and read their position paper, dated last month, talking about this very question. And there is an entire topic devoted to the proposition that, ". . . originators should not be required to disclose their compensation." I do not understand.

Chairman SARBANES. Does anyone want to respond to that?

Mr. Falk.

Mr. FALK. Mr. Chairman——

Chairman SARBANES. We have you all at the table this morning for this purpose.

Yes.

Mr. FALK. Mr. Chairman, we as the mortgage brokers do believe in comprehensive mortgage reform. I believe over the last 5 or 6 years the National Association of Mortgage Brokers has been calling on Congress and HUD to work on the various problems that we have in our industry.

There are just too many pieces of paper. It is confusing to the consumer. It can be faster and better, understandable to the consumer, to facilitate shopping and comparing. It can be better.

We believe also an important part of this is RESPA enforcement that Secretary Martinez has called for and we applaud that effort. We look forward to his efforts in enforcing the rules that are currently on the books and clarifying others that need clarification.

Last, we have called for more than what the HUD Secretary called for in our press release recently. We have called for Good Faith Estimate reform, which would have caused some of the problems that we heard about this morning not to exist.

Right now, Mr. Chairman, when a Good Faith Estimate is required, there is no Federal requirement to redisclose the Good Faith Estimate of costs if the loan terms change significantly from the time of application to the time of funding.

What we are saying is develop tolerances. When the Good Faith Estimate is initially constructed and delivered to the consumer, if tolerances are exceeded, then a redisclosure is necessary to avoid the surprises at the closing table, to avoid some of the things that we heard this morning on a purchase transaction, the story that we heard this morning from Ms. Hiers, who felt forced to close a transaction. That should not happen. And redisclosure on a Good Faith Estimate that exceeds certain tolerances could be a valuable tool for consumers so they are not taken advantage of.

Chairman SARBANES. Well, all three people we heard from before, I was struck by the fact that these are really hard-working citizens. Every one of them.

Their dream was to own a home, and that was obviously a very important part of providing security for their families. Ms. Hiers actually had her parents living with her until they passed away, along with her children. We have to get at these practices.

Mr. Jackson, I know you have looked at the RESPA legislation in detail. My own reaction to the HUD 2001 policy statement was that, rather than clarifying the 1999 statement, it actually muddied the waters.

My view of the RESPA law, in the 1999 statement was that each fee had to be tied to a legitimate service. In fact, the Senate report that accompanied the passage of RESPA indicates that RESPA, ". . . prohibits the acceptance of any portion of any charge for the rendering of a real estate settlement service other than for services actually performed." So my understanding is that Congress wanted to prohibit referral fees from being tacked onto or hidden in with other fees that were for legitimate services or goods.

And that is why, Mr. Falk, I kept pressing you specifically on the fee and the service because you can encompass the fee within a broader concept. And I have some concern now that this is what HUD is doing with this total compensation test, which would allow for referral fees, or may well allow for referral fees as long as HUD believes that the total payment to the broker is reasonable, even though the law specifically prohibits all referral fees.

Now do you share that concern, Professor Jackson?

Mr. JACKSON. Senator Sarbanes, I do. This aspect of the policy statement is quite puzzling. If you go back to the legislative history of the Act that you are referring to, or even the press accounts that preceded the Act, what Congress was worried about were people in a trust relationship, like attorneys or real estate agents, who were steering their clients toward title insurance companies and other service providers and getting a kickback. And what Congress concluded was that these referral fees and kickbacks were increasing substantially homeownership costs, and they should prohibit them.

Chairman SARBANES. Mr. Donaldson, the Culpepper case in effect said, as I understand it, that these yield spread premiums were being paid without any relationship to providing any services.

Mr. DONALDSON. Yes, sir.

Chairman SARBANES. Is that correct?

Mr. DONALDSON. Yes, sir, that is correct.

Chairman SARBANES. In effect, you had the rate sheet and it was all geared to the rate sheet. As long as you brought them in at a higher interest rate, you got the yield spread premium and you, the broker, did not really have to do anything for that yield spread premium. Is that the essential thrust of that case?

Mr. DONALDSON. Yes, sir. And the form agreement between the lender and the broker simply provided that yield spread premium payments would be made when a borrower agrees to a higher than par interest rate. It had nothing to do with services. And in fact, at the outset of that litigation, the defendant did not even argue that it had to do with services. It argued that it was paying for a good which was the mortgage. This idea that this is a payment for services is something that was cooked up by industry lawyers after they lost their first argument.

Chairman SARBANES. My understanding is that there has been testimony in some of these class action suits—let me just quote a couple of them.

A broker testified in a deposition that the only variable that determines the yield spread is the interest rate. A lender official was asked if there are any particular services that go into the pricing on a rate sheet. His answer, "No, I am not aware of any services."

Mr. DONALDSON. That is correct.

Chairman SARBANES. A lender offers to fund the same exact loan provided by the same broker for the same borrower with the same principle amount after the broker has done the work. The only variable is the yield spread premium, which is predetermined according to a rate sheet provided by the lender to the broker. Isn't that what happens?

Mr. DONALDSON. Yes, sir, that is exactly what happens.

Chairman SARBANES. Mr. Jackson, let me ask you one other question on this RESPA and the HUD statement. Apparently, now, the 2001 statement is that HUD is going to determine what is a reasonable fee. That is not the approach that the Congress took when they passed the legislation, at least as I understand it. In fact, we did not set up a structure to adjudge the reasonableness of the fees.

Mr. JACKSON. That is absolutely right.

Chairman SARBANES. Mr. Courson, Mr. Falk, do you think we should set up a structure to adjudge the reasonableness of fees, a Government structure to do that?

Mr. COURSON. Mr. Chairman, I think that is a very slippery slope. I think it is very difficult to judge what, when one loan may well be reasonable—we are talking about loans now in this particular context—and whether another loan may be unreasonable.

You have geographical issues. You have different types of loans. I think that the Government setting standards, if you will, in terms of defining reasonableness will be very difficult over the hundreds of thousands of loans that are made each year.

Chairman SARBANES. Mr. Falk, I take it you would agree with that.

Mr. FALK. I would add to the comment, yes, I do agree with Mr. Courson's testimony. Many loan programs and different products and services call for different types of services and goods and facilities rendered. Therefore, it is impossible to come up with a strict definition on a Federal level to deal with all of the complexity that goes into a particular loan transaction on a local level. It would just be very difficult.

Chairman SARBANES. Actually, I do not think anyone at the table is advocating establishing a governmental structure to adjudge the reasonableness of fees. Is that correct?

Mr. OLSON. That is correct.

Chairman SARBANES. I mean, as I read it, that is not the legislative scheme the Congress put in place.

Now what the Department is doing is, conceivably—we are going to see now because they are working on a regulation—but, conceivably, undercutting the existing regulatory scheme, setting up this kind of reasonableness proposition.

I do not know how that is going to be implemented or enforced. The industry, obviously, in its full-scale manifestation, would be opposed to it. The Congress made the judgment when we passed the legislation not to go down that path. But if we are not going to go down that path, it seems to me that HUD cannot abandon the two-stage testing process for these practices that in part were reflected by the court's decisions in the Culpepper case. So now if they are going to come in and vitiate the Culpepper case, it is hard for me to see what the remedy is going to be to preclude these practices from taking place.

Mr. RHEINGOLD. Senator.

Chairman SARBANES. So, I think that is, in effect, the challenge that HUD has presented to itself. They, in effect, now, it seems to me, have maneuvered themselves into a corner. And I am obviously very interested in how they are going to work out of this corner.

Mr. Rheingold, you wanted to comment?

Mr. RHEINGOLD. I apologize.

Chairman SARBANES. That is all right. No, no.

Mr. RHEINGOLD. The industry, in fact, supported HUD's action and wanted them to apply a reasonableness test. HUD adopted what the industry was asking them to do, and there was one reason for it and one reason alone—everyone understands that if the only test is reasonableness, you cannot have a class action lawsuit.

HUD's actions were simple. Call it cynical. The only purpose for their policy statement on October 15 was to undercut Culpepper. They may come out now with new regulations that are helpful. But the fact was that the October 15 Statement of Policy was caused by industry's reaction to the Culpepper decision and their understanding that a reasonableness test would undercut the ability of any class action to go forward.

Chairman SARBANES. Do you think that there are mandates that could now be required of the industry that would preclude a repeat of the practices we saw on the first panel?

Mr. RHEINGOLD. I think there clearly are. Actually, I think some of the suggestions that Mr. Courson made are very viable. I think the notion that total compensation up front, that the total compensation does not depend upon the interest rate the person gets. The yield spread premium is simply a source of how that compensation gets paid. So, in essence, there is no incentive for a broker to get a higher rate mortgage because they are not going to get compensated any more.

I think that would go a long way to solving the problems that exist. I hasten to add that in my experience in representing a lot of poor homeowners in this country, I never underestimate the cynicism of the industry and I never underestimate——

Chairman SARBANES. Or some elements of the industry.

Mr. RHEINGOLD. Some elements of the industry. I do not mean the entire, but some elements. I do not underestimate that. But I think that would go a long way forward in making things work.

Chairman SARBANES. I think the industry has to face this problem of the bad actors within their ranks. They just have to face it.

Mr. Falk, do you want to comment?

Mr. FALK. Yes. Thank you, Mr. Chairman. I would vociferously disagree with the other panelists who have tried to characterize the

2001–1 policy statement of HUD. We believe that the 1999–1 policy statement by Secretary Cuomo clearly outlined the requirements. We believe that the 2001–1 statement was merely a restatement of that existing policy that was originally stated in 1999.

And so, to characterize it as some effort on the part of the HUD Secretary to undermine or to take away certain rights and privileges from consumers, we believe is a misinterpretation, with all due respect to the other panelists.

Chairman SARBANES. Yes. The difficulty I have with that statement, though, is that under the 1999 guidance, a class action suit was permitted in the Culpepper case. And since the new guidance has come out, I understand that there have been a couple of Federal courts across the country who have disallowed the class action suit. So if you see the class action suit as one effective remedy to eliminate these practices, then that remedy has been in effect wiped out.

Also, HUD, by collapsing the two-step test, has markedly altered the situation. If it is left for reasonableness to be determined in a court case, that is not much remedy on an individual basis.

They are not suggesting establishing a structure to determine reasonableness administratively, and of course, both of you would strongly disagree with going down that path, I presume, from what you have said earlier.

So, we have a situation now in which the remedies are being eliminated on the basis of a so-called clarifying statement compared with where we were before. The rhetoric of the HUD press releases in terms of what they are trying to accomplish does not comport with the reality of their statement, in my perception. It will really be put to the test, obviously, as we look at the regulation that they are now seeking to formulate. And obviously, we intend to follow that process very closely.

Well, I want to thank all the panelists. You have made a very significant contribution. It is our intention that your full statements and the transcript of this hearing will be forwarded to the Department, along with a letter of communication urging them to give the most careful consideration to what has been said here.

This is a very important issue. As I said at the outset, people who render services are entitled to appropriate compensation for the services they render. But it ought not to extend to the point where they can engage in abusive practices and exploit people.

Mr. Olson, I was a little concerned you were suggesting they are not making much money. That may or may not be the case. But, in any event, in order to make money, I do not think you are entitled to engage in abusive practices. I do not concede that in order to turn a profit, you can engage in any exploitative activity.

Mr. OLSON. I did not mean to suggest that.

Chairman SARBANES. Well, that was a possible implication. I just want to be very clear about that.

I thank the panel very much.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional materials supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

This morning the Committee will hold its third hearing on the subject of predatory lending. Our previous two hearings on this topic focused largely on the predatory loans and practices which resulted in stripping hard-earned equity away from many low-income homeowners. These include folding high points and fees, as well as products such as credit insurance, into the loan. We also looked at how unscrupulous lenders and mortgage brokers target the low-income, elderly, and uneducated borrowers as likely marks for predatory loans. Today's hearing will focus more on the role of the broker in the lending process, specifically the use and misuse of yield spread premiums.

Let me start by addressing how yield spreads are used in the marketplace. Typically, a mortgage broker will offer to shop for a mortgage on behalf of a consumer. In many cases, that broker will promise to get the borrower a good deal, meaning low rates and fees. Borrowers pay the broker a fee for this service, either out of their savings or with the proceeds of the loan. Unbeknownst to them, however, that broker may also be paid a yield spread premium if he can get the borrower to sign up for a loan at a higher rate than the borrower qualifies for. The higher the mortgage rate, the higher the payment. We will hear about such cases this morning.

Yield spread premiums can be a legitimate tool in helping a home buyer or homeowner offset all or some of the closing costs associated with buying or refinancing a home. When used properly, the broker discloses his total fee to the consumer. The consumer may then choose to pay that fee, and, perhaps other closing costs as well, by accepting a higher interest rate and having the lender pay the fee to the broker. In such cases where the borrower makes an informed choice the payment helps families overcome a barrier to homeownership—the lack of funds for closing costs.

However, it appears that in practice, perhaps in widespread practice, yield spread premiums are not used to offset closing costs or the broker fees. Instead, these premiums are used to pad the profits of mortgage brokers, without regard to any services they may provide to borrowers. Let me quote from a report issued by the Financial Institutions Center at the Wharton School of Business at the University of Pennsylvania. Professor Emeritus Jack Guttentag, discussing the problem of "rebate pricing" that is, payments by lenders to brokers of yield spread premiums, writes:

> In most cases . . . rebates can be pocketed by the broker, unless the broker commits to credit them to the borrower, which very few do. Rebate pricing [that is YSP's] has been growing in importance, and one of the reasons is that it helps mortgage brokers conceal their profit on a transaction.

Moreover, this does not just affect subprime borrowers, as do most of the other egregious practices we heard about in our previous hearings. This misuse of yield spread premiums affects prime borrowers, FHA borrowers, VA borrowers; however, because of the lack of openness and competition in the subprime market, it hits subprime borrowers hardest of all. Even for those with the best credit, the current use of yield spread premiums can cost thousands of dollars in increased financing costs.

Yield spread premiums, when they are misused in this way, fall directly into the category of the kind of referral fees or kickbacks that were so prevalent in the settlement business prior to the passage of RESPA. After years of hearings and reports, the Congress passed the Real Estate Settlement Procedures Act (RESPA) in 1974 specifically to outlaw side payments of this kind because they increase the costs of homeownership for so many Americans. Indeed, the plain language of the law, regulations, 1998 Congressional instructions to HUD to formulate a policy on the issue, and the 1999 HUD policy statement—particulary when taking the legislative history into account—all make it clear that RESPA was intended to prohibit all payments that are not demonstrably and specifically for actual services provided. That is to say, each fee collected by the broker should be for a corresponding service actually provided.

Because the majority of home loans are now originated through brokers, lenders have less and less direct access to borrowers. This means they must compete for the broker's attention to gain access to the ultimate consumer—the borrower. This competition means that, too often, lenders must pay yield spread premiums to the brokers simply for the referral of business. As all of us know, this is prohibited under the law precisely because it raises the costs of homeownership to the consumers.

Regrettably, HUD's recent "clarification" of its 1999 policy statement on the issue of yield spread premiums will open the door to new and ongoing abuses of low- and moderate-income homebuyers and owners. Despite the Secretary's statement at his confirmation hearing that he finds predatory lending "abhorrent," I fear that the new policy statement will facilitate the predatory and racially discriminatory practice of steering homeowners to higher interest rate loans without their knowledge, and, importantly, without any effective means of redress.

Secretary Martinez has made increasing minority homeownership a primary goal of his Administration. However, a study done by Howell Jackson of Harvard Law School (who will testify on the second panel) shows that, while the current use of yield spread premiums imposes extra costs on all homebuyers, the burden falls especially hard on minorities. In other words, yield spread premiums, when they are used in this abusive fashion, put the dream of homeownership further out of reach for minority Americans. Those who still manage to achieve this dream are forced to pay thousands of dollars in increased interest costs over the life of their loans. Many find themselves in more precarious financial positions than they should or could be, thereby putting them more at greater risk of falling prey to the kind of repeated refinancings that we have seen lead to equity stripping or even the loss of the home.

I recognize that it is unusual to have a hearing while the Congress is in recess. HUD has indicated, both in testimony before this Committee in December, and in the *Federal Register,* that it intends to publish a proposed regulation on this matter by the end of this month. These issues are so important that I wanted to make sure that there would be a public airing of the issues for the consideration of the Department while their deliberations were still ongoing.

PREPARED STATEMENT OF SUSAN M. JOHNSON

COTTAGE GROVE, MINNESOTA

JANUARY 8, 2002

My name is Susan Johnson and I am from Cottage Grove, Minnesota. I am pleased to have the opportunity to be able to address the Senate Banking Committee today about the $1,620 "yield spread premium" that was secretly paid by my lender, ABN AMRO Mortgage Group, to my mortgage broker, Allstate Mortgage, at my expense.

In April 2000, my husband David and I had just moved back to the Twin Cities from Colorado Springs and were looking to buy a house. Through a real estate agent, we were introduced to David Schultz, owner of Allstate Mortgage, a mortgage broker in Plymouth, Minnesota. After meeting Mr. Schultz at a local restaurant, we hired him to find us a mortgage loan.

From the outset, we were told by Mr. Schultz that he would find us a loan with the best possible interest rate. Mr. Schultz specifically told us that the fee for processing the loan would be 1 percent of the loan amount. We signed a written broker agreement with Mr. Schultz which allowed for a 1 percent broker fee. (Exhibit 1, Loan Origination Agreement) No other fees were ever demanded by Mr. Schultz, disclosed, or agreed to.

When the closing occurred on May 23, 2000, to our surprise, the interest rate was higher than we understood it would be and the fees were far greater than the 1 percent fee we had agreed to. (Exhibit 2, HUD–1 Settlement Statement at lines 801–812) In fact, the total fees were nearly four times that amount! ($5,242.00) This included what we only later came to learn after the closing was a "yield spread premium"—a $1,620 payment from the lender to our broker that was really paid by us since it was tied to an inflated interest rate on our loan.

While we were upset about the fees, we had no choice but to go through with the closing or risk losing the house; being found in default of the Purchase Agreement; and forfeiting the $5,000 earnest money we had already given the sellers. While we objected to the fees and higher interest rate, there was no way for us to find another loan and still close on time. We were stuck and the broker knew it.

As our HUD–1 Settlement Statement shows, we were charged the following fees at closing, none of which were disclosed, or agreed to beyond the initial 1 percent origination fee:

$1,296 (1 percent) Loan Origination Fee
$1,296 (1 percent) Loan Discount Fee
$395 Processing Fee
$200 Underwriting Fee
$150 Doc Prep Fee
$40 Funding Fee
$350 Commitment Fee
$285 Admin Fee

Only after the closing did we discover the significance of the $1,620 "yield spread premium" (1.25 percent) which was assessed to us through an inflated above-par interest rate of 8.75 percent. At the time of the closing we had no idea what this "premium" was because it was only vaguely disclosed on our HUD–1 Settlement Statement as a "Deferred Premium POC."[1] In sum:

The $1,620 yield spread premium was not disclosed, discussed, or agreed to before the closing;

My husband and I were never informed that our loan had an above-par interest rate because of the premium payment from ABN AMRO to the broker;

The broker never explained how the yield spread premium affected our interest rate or that our monthly mortgage payments would be any higher because of the premium;

No rate sheet or other document showing the direct relationship between the inflated interest rate and the yield spread premium payment from the lender to the broker was ever shown to us;

The yield spread premium did not offset or reduce any fee we ever owed to the broker;

The broker received all fees that we owed and agreed to (and far more) directly in cash from us at the closing.[2]

After the closing, I wrote to the State of Minnesota Department of Commerce complaining about the transaction. After reviewing my letter, the Department of Commerce advised us to seek private legal counsel. The matter remains pending in Court in Minnesota. In that case, we have agreed to be representatives of other borrowers whose loans had yield spread premiums paid by the same lender in the same manner as ours.

In conclusion, the $1,620 yield spread premium on our loan was nothing more than a bonus paid by the lender to the broker for securing a bad deal for my husband and me, and referring a better deal to the lender. This conduct should be illegal because:

(1) the yield spread premium was not paid in exchange for any "service" fee we owed the broker;

(2) we received no benefit from the premium the lender paid at our expense, such as an offsetting credit against any closing fees or costs we actually owed, and;

(3) the money was simply a kickback to the broker referring our loan to the lender with a higher interest rate.

The standard for evaluating the legality of this practice should not merely be whether the broker's "total compensation," including the yield spread premium and other fees we never agreed to, is somehow "reasonable" based on the broker's after-the-fact attempt to justify the higher fees he has already taken. Rather, the true nature of the disputed premium should be evaluated: that is, what was the premium actually paid in exchange for.

To allow as lax a standard as "reasonableness" of total broker compensation to govern these transactions will only allow lenders and brokers like ABN AMRO and Mr. Schultz to continue ripping-off unknowing consumers like us, with a catch-us-if-you-can attitude. It will encourage brokers and lenders to continue to try to slip additional bonus fees into mortgage transactions regardless of what was agreed and without providing any actual credit to the consumer bearing the cost. If lenders are paying bonuses and incentives to brokers simply for referring high-rate loans to them, that should be illegal without concern for whether the broker or the lender thought the secret referral fee was "reasonable."

Thank you.

Attachments

Exhibit 1: Loan Origination Agreement with the broker for the 1 percent fee; HUD–1 Settlement Statements (Exhibit 1);

Exhibit 2: HUD–1 Settlement Statement on ABN AMRO Mortgage Group Inc. loan, May 23, 2000;

[1] Line 814 "Deferred Premium $1,620 ($1,620 Pd by ABN AMRO Mortgage Group Inc., POC) to Allstate Home Mortgage."

[2] We never owed the broker any fees on top of the 1 percent fee Mr. Schultz told us he was charging before the closing. Mr. Schultz later admitted this when he gave a deposition. (Exhibit 3: Excerpts from Schultz deposition, March 15, 2001).

Exhibit 3: Excerpts from Mr. Schultz's deposition testimony admitting that the yield spread premium was never discussed with us before the closing and offset no fee we owed.

Exhibit 1

MORTGAGE LOAN ORIGINATION AGREEMENT

You, the applicant(s) agree to enter into this Mortgage Loan Origination Agreement with Allstate Home Mortgage (hereinafter referred to as "we" or "us") as an independent contractor to apply for a residential mortgage loan from a participating lender with which we from time to time contract upon such terms and conditions as you may request or a lender may require. You inquired into mortgage financing with us on __________. We are licensed as a "Mortgage Broker" or "Mortgage Lender" (circle one) under Minnesota Real Estate Law.

SECTION 1. NATURE OF RELATIONSHIP. In connection with this mortgage loan we are acting as an independent contractor and not as your agent. We will enter into separate independent contractor agreements with various lenders. While we seek to assist you in meeting your financial needs, we do not distribute the products of all lenders or investors in the market and cannot guarantee the lowest price or best terms available in the market.

SECTION 2. OUR COMPENSATION. The Client hereby authorizes the Broker to negotiate a loan (MORTGAGE) of $__________, or such amount that is mutually satisfactory. As consideration for this, the Client agrees to pay $__________ or __________%.

The client agrees and understands that the fee is due and payable upon loan funding. The Client further agrees and understands that the fee will be deducted from the loan proceeds and the Client hereby agrees to allow the lender to disburse the fee directly to the Broker and to finance the Broker fees in the loan. In the event that the client does not want to finance the Broker fee in the loan, then the client agrees to pay the fee in the form of a cashiers check or certified check at the time of loan funding. The draft is to be made payable to: Allstate Home Mortgage.

It is agreed and understood that if the Broker obtains a loan approval for you and you choose not to close, you are not obligated to pay the Broker. You are only obligated to pay the Broker if the loan funds.

The costs to obtain your loan may change based on lender decisions. Changes in the cost are based upon, but not limited to the following items: Property Type, Credit Worthiness, Job Stability, Income, Loan to Value, Loan Term, Loan Type and Loan Amount.

The Client agrees and understands that the Broker does not make rate and point commitments; these are made by the lender. It is further agreed and understood that the Client release and indemnity (including reasonable attorney fees) the Broker from any disputes or liabilities that may arise between the Client and the lender.

The lenders whose loan products we distribute generally provide their loan products to us at a wholesale rate. The retail price we offer you—your interest rate, total points and fees—will include our compensation. In some cases, we may be paid all of our compensation by either you or the lender. Alternatively, we may be paid a portion of our compensation by both you and the lender. For example, in some cases, if you would rather pay a lower interest rate, you may pay higher up-front points and fees. Also, in some cases, if you would rather pay less up-front, you may be able to pay some or all of our compensation indirectly through a higher interest rate in which case we will be paid directly by the lender. We also may be paid by the lender based on (i) the value of the Mortgage Loan or related servicing rights in the market place or (ii) other services, goods or facilities performed or provided by us to the lender.

The Client agrees that any claim or dispute between or among them or against any agent, successor, or assignee of either, whether related to this agreement or otherwise, and any claim related to this agreement, regardless against whom made, shall be resolved by biding arbitration by and under the Code of Procedure of the National Arbitration Forum and any Award of the arbitrator(s) may be entered in any Court of competent jurisdiction. Claims may be filed at any office of the National Arbitration Forum or by mail at Post Office Box 50191, Minneapolis, MN 55405. This agreement shall be subject to the Federal Arbitration Act.

By signing, below, applicant(s) acknowledge receipt of a copy of this Agreement.

Signature Borrower 1:	Signature Borrower 2:
Print Name:	Print Name:
Date:	Address:
Broker or Authorized Agent Signature:	
Print Name:	Date:
Broker Address:	

EXHIBIT

tabbies

1

ORIGINATION AGREEMENT

Exhibit 2

OMB NO. 2502-0265

A.

U.S. DEPARTMENT JSING & URBAN DEVELOPMENT

SETTLEMENT STATEMENT

B. TYPE OF LOAN:

1. ☐ FHA 2. ☐ FmH 3. ☒ CONV. UNINS. 4. ☐ VA 5. ☐ CONV. INS.

6. FILE NUMBER: 0005025

7. LOAN NUMBER: 611098003

8. MORTGAGE INS CASE NUMBER:

C. NOTE: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(POC)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

1.0 3/03 (0005025/11)

D. NAME AND ADDRESS OF BORROWER:
David L. Johnson and
Susan M. Johnson
1955 Lacti
Colorado Springs, CO 80915

E. NAME AND ADDRESS OF SELLER:
Starla J. Swanson-Danielson
7210 Jenner Alcove
Cottage Grove, MN 55016

F. NAME AND ADDRESS OF LENDER:
ABN AMRO Mortgage Group, Inc.
2600 W. Big Beaver Road
Troy, MI 48084

G. PROPERTY LOCATION:
7210 Jenner Alcove
Cottage Grove, MN 55016
Washington County, Minnesota

H. SETTLEMENT AGENT: 41-1929678
West Title, LLC

PLACE OF SETTLEMENT
6009 Wayzata Blvd., Suite 105
St. Louis Park, MN 55416

I. SETTLEMENT DATE:
May 23, 2000

J. SUMMARY OF BORROWER'S TRANSACTION	
100. GROSS AMOUNT DUE FROM BORROWER:	
101. Contract Sales Price	162,000.00
102. Personal Property	
103. Settlement Charges to Borrower (Line 1400)	6,377.27
104.	
105.	
Adjustments For Items Paid By Seller in advance	
106. City/Town Taxes to	
107. County Taxes 05/23/00 to 07/01/00	172.41
108. Assessments to	
109.	
110.	
111.	
112.	
120. GROSS AMOUNT DUE FROM BORROWER	168,549.68
200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER:	
201. Deposit or earnest money	5,000.00
202. Principal Amount of New Loan(s)	129,600.00
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments For Items Unpaid By Seller	
210. City/Town Taxes to	
211. County Taxes to	
212. Assessments to	
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. TOTAL PAID BY/FOR BORROWER	134,600.00
300. CASH AT SETTLEMENT FROM/TO BORROWER:	
301. Gross Amount Due From Borrower (Line 120)	168,549.68
302. Less Amount Paid By/For Borrower (Line 220)	(134,600.00)
303. CASH (X FROM) (TO) BORROWER	33,949.68

K. SUMMARY OF SELLER'S TRANSACTION	
400. GROSS AMOUNT DUE TO SELLER:	
401. Contract Sales Price	162,000.00
402. Personal Property	
403.	
404.	
405.	
Adjustments For Items Paid By Seller in advance	
406. City/Town Taxes to	
407. County Taxes 05/23/00 to 07/01/00	172.41
408. Assessments to	
409.	
410.	
411.	
412.	
420. GROSS AMOUNT DUE TO SELLER	162,172.41
500. REDUCTIONS IN AMOUNT DUE TO SELLER:	
501. Excess Deposit (See instructions)	
502. Settlement Charges to Seller (Line 1400)	7,506.10
503. Existing loan(s) taken subject to	
504. Payoff of first Mortgage to Countrywide Home Loans	97,566.45
505. Payoff of second Mortgage	
506. Deposit retained by broker	5,000.00
507.	
508.	
509.	
Adjustments For Items Unpaid By Seller	
510. City/Town Taxes to	
511. County Taxes to	
512. Assessments to	
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. TOTAL REDUCTION AMOUNT DUE SELLER	110,072.55
600. CASH AT SETTLEMENT TO/FROM SELLER:	
601. Gross Amount Due To Seller (Line 420)	162,172.41
602. Less Reductions Due Seller (Line 520)	(110,072.55
603. CASH (X TO) (FROM) SELLER	52,099.86

The undersigned hereby acknowledge receipt of a completed copy of pages 1&2 of this statement & any attachments referred to herein.

I HAVE CAREFULLY REVIEWED THE HUD-1 SETTLEMENT STATEMENT AND TO THE BEST OF MY KNOWLEDGE AND BELIEF, IT IS A TRUE AND ACCURATE STATEMENT OF ALL RECEIPTS AND DISBURSEMENTS MADE ON MY ACCOUNT OR BY ME IN THIS TRANSACTION. I FURTHER CERTIFY THAT I HAVE RECEIVED A COPY OF THE HUD-1 SETTLEMENT STATEMENT.

Borrower ______________________
David L. Johnson

____
Susan M. Johnson

Seller ______________________
Starla J. Swanson-Danielson

TO THE BEST OF MY KNOWLEDGE, THE HUD-1 SETTLEMENT STATEMENT WHICH I HAVE PREPARED IS A TRUE AND ACCURATE ACCOUNT OF TH FUNDS WHICH WERE RECEIVED AND HAVE BEEN OR WILL BE DISBURSED BY THE UNDERSIGNED AS PART OF THE SETTLEMENT OF THIS TRANSACTION.

____
West Title, LLC
Settlement Agent

WARNING: IT IS A CRIME TO KNOWINGLY MAKE FALSE STATEMENTS TO THE UNITED STATES ON THIS OR ANY SIMILAR FORM. PENALTIES UPO CONVICTION CAN INCLUDE A FINE AND IMPRISONMENT. FOR DETAILS SEE: TITLE 18 U.S. CODE SECTION 1001 & SECTION 1010.

EXHIBIT
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HUD-1 (3/86) RESPA, HB 4305.2

L. SETTLEMENT CHARGES

	PAID FROM BORROWER'S FUNDS AT SETTLEMENT	PAID FROM SELLER'S FUNDS AT SETTLEMENT
700. TOTAL COMMISSION Based on Price $ 162,000.00 @ 7.0000 % 11,340.00		
Division of Commission (line 700) as Follows:		
701. $ 11,340.00 to Coldwell Banker Burnet		
702. $ to		
703. Commission Paid at Settlement		6,340.00
704. Administration Fee to Coldwell Banker Burnet		155.00
800. ITEMS PAYABLE IN CONNECTION WITH LOAN		
801. Loan Origination Fee 1.0000 % to Allstate Home Mortgage	1,296.00	
802. Loan Discount 1.0000 % to Allstate Home Mortgage	1,296.00	
803. Appraisal Fee to Allstate Home Mortgage POC $325.00b		
804. Credit Report to Allstate Home Mortgage POC $58.00b		
805. Processing Fee to Allstate Home Mortgage	395.00	
806. Underwriting Fee to ABN AMRO Mortgage Group, Inc.	200.00	
807. Doc Prep Fee to ABN AMRO Mortgage Group, Inc.	150.00	
808. Deferred Prem pd by lender to Allstate Home Mortgage POC $1,620.00b		
809. Funding Fee to ABN AMRO Mortgage Group, Inc.	40.00	
810. Flood Cert Fee to ABN AMRO Mortgage Group, Inc.	10.00	
811. Commitment Fee to Allstate Home Mortgage	350.00	
812. Flood Certification Fee to Allstate Home Mortgage	28.50	
813. Administration Fee to Allstate Home Mortgage	285.00	
814.		
815.		
816.		
817.		
818.		
819.		
820.		
900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE		
901. Interest From 05/23/00 to 06/01/00 @ $ 31.500000/day (9 days %)	283.50	
902. Mortgage Insurance Premium for months to		
903. Hazard Insurance Premium for 1.0 years to POC $563.00b		
904.		
905.		
1000. RESERVES DEPOSITED WITH LENDER		
1001. Hazard insurance 3.000 months @ $ 46.92 per month	140.76	
1002. Mortgage insurance months @ $ per month		
1003. City/Town Taxes months @ $ per month		
1004. County Taxes 4.000 months @ $ 141.17 per month	564.68	
1005. Assessments months @ $ per month		
1006. months @ $ per month		
1007. months @ $ per month		
1008. Aggregate Adjustment months @ $ per month	-141.25	
1100. TITLE CHARGES		
1101. Settlement or Closing Fee to West Title, LLC/Burnet Title	225.00	215.00
1102. Abstract or Title Search to West Title, LLC		157.00
1103. Title Examination to West Title, LLC	125.00	
1104. Title Insurance Binder to		
1105. Document Preparation to		
1106. Notary Fees to		
1107. Attorney's Fees to		
(includes above item numbers:)		
1108. Title Insurance to West Title, LLC	642.50	
(includes above item numbers:)		
1109. Lender's Coverage $ 129,600.00 362.50		
1110. Owner's Coverage $ 162,000.00 280.00		
1111. ARM Endorsement West Title, LLC		
1112. Balloon Endorsement West Title, LLC		
1113. Plat Drawing to West Title, LLC	50.00	
1114. Special Assessment Search to West Title, LLC		30.00
1115. Name Search to West Title, LLC	20.00	
1116. Courier Fee-Payoffs to West Title, LLC		25.00
1117. Recording Service Charge to West Title, LLC	45.00	15.00
1118.		
1200. GOVERNMENT RECORDING AND TRANSFER CHARGES		
1201. Recording Fees: Deed $ 19.50; Mortgage $ 19.50; Releases $ 29.50	39.00	29.50
1202. City/County Tax/Stamps: Deed ; Mortgage		
1203. State Tax/Stamps: Revenue Stamps 534.60; Mortgage 298.08	298.08	534.60
1204. Record Affidavit of Non-ID to West Title, LLC	29.50	
1205. Conservation Fee to Washington County	5.00	5.00
1300. ADDITIONAL SETTLEMENT CHARGES		
1301. Survey to		
1302. Pest Inspection to		
1303.		
1304.		
1305.		
1400. TOTAL SETTLEMENT CHARGES (Enter on Lines 103, Section J and 502, Section K)	6,377.27	7,506.1

By signing page 1 of this statement, the signatories acknowledge receipt of a completed copy of page 2 of this two page statement.

West Title, LLC
Settlement Agent

[illegible]

Exhibit 3

See, Schultz deposition at page 65-66:

Q. So the Johnsons obtained a loan that had an above-par interest rate?
A. Correct.
Q. Did you ever communicate to the Johnsons what the par interest rate was?
A. Not to my knowledge.
Q. Did you ever show the rate sheet which you used to register the Johnson's loan? Did you ever show that rate sheet to the Johnsons?
A. No.
Q. Did you ever inform the Johnsons that their loan was at a rate above ABN AMRO's par rate?
A. Not specifically, no.

* * *

Q. On top of the loan origination fee of $1296, the loan discount fee of $1296, the processing fee of $395, the commitment fee of $350, the fee on line 812 of $28.50 and the administration fee of $285 which the Johnsons directly paid to you, did you ever tell them that they owed you any more money in this transaction?
A. No.

Schultz Deposition at 72-73:

Q. Prior to closing you never discussed that premium with them, did you?
A. No, I did not.

* * *

Q. Did you ever send the Johnsons some type of bill for $1620 on top of the direct fees which they paid to Allstate directly at the closing?
A. Never sent them a bill.
Q. Was there any type of invoice or statement or any other type of document whatsoever that indicated to the Johnsons at any time prior to May 23, 2000 [date of closing] that they somehow owed Allstate an additional $1620 on top of all the direct fees they were paying already, the origination fee, the discount fee, commitment fee, administration fee, et cetera.
A. There was never a bill sent, no.

Schultz Deposition at 75:

Q. So you've never discussed the premium with her after the closing or before the closing?
A. I do not believe so, no.

Schultz deposition at page 87:

Q. Did you give them anything else, any other document which showed the direct relationship between the above par interest rate and the size of the premium ABN AMRO would pay to Allstate?
A. No.

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Schultz Deposition page 89:

Q. Was there anything specific that was ever given to the Johnsons that showed that they owed you $1620 on top of each of these other fees that they paid directly?
A. Not exactly that dollar amount, no.

Schultz Depsition page 92:

Q. What I'm asking you is: Is there a specific fee that the premium offset that the Johnsons owed you and which you disclosed to them?
A. No.

Schultz Deposition at 180:

Q. But to answer my question, did you ever tell the Johnsons that they owed you $1620 and that premium was somehow paid for [that]?
A. No.
Q. And the Johnsons never told you that they were intentionally electing to have an above-par interest rate in order to finance a fee of $1620 that they otherwise would have owed your firm, your company, in cash, did they?
A. No.

A. Uh-huh.
Q. What is that? Tell me what your understanding of the term par interest rate is.
A. Par means you would get 0 premium.
Q. Is a premium paid when a loan is registered or locked at a rate which is above the par interest rate?
A. I don't know how they determine that. I mean, once again, we look at what we need to make on the loan and that's how we lock them in.
Q. Was 8.75 percent the par interest rate on ABN AMRO's rate sheet on the date which you authored the loan?
A. No, it wasn't.
Q. Was the par rate less than 8.75 percent?
A. I assume that it was, yes.
Q. So the Johnsons obtained a loan that had an above par interest rate?
A. Correct.
Q. Did you ever communicate to the Johnsons what the par interest rate was?
A. Not to my knowledge.
Q. Did you ever show the rate sheet which was used to register the Johnson's loan? Did you

ever show that rate sheet to the Johnsons?
A. No.
Q. Did you ever inform the Johnsons that their loan was at a rate above ABN AMRO's par rate?
A. Not specifically, no.
Q. Do you know what the par rate was on the date which they locked in the loan?
A. I don't recall.
Q. Do you retain copies of the rate sheets?
A. Usually we do, yes.
Q. Would the Johnson's file in your office have a copy of the applicable ABN AMRO rate sheet?
A. I believe it should be in the file, yes.
Q. On top of the loan origination fee of 1296, the loan discount fee of 1296, the processing fee of 395, the commitment fee of $350, the fee on line 812 of 2850 and the administration fee of 285 which the Johnsons directly paid to you, did you ever tell them that they owed you any more money in this transaction?
A. No.
MR. HERTZ: Objection to the form of the question.

BY MR. ROBINOVITCH:
Q. Your answer was no?
A. No.
Q. So other than the direct fees which they paid, they didn't -- the Johnsons did not owe Allstate any more money did they?
MR. MACLIN: Object to the form.
MR. HERTZ: Object to the form.
THE WITNESS: The fees are right here on the HUD statement.
BY MR. ROBINOVITCH:
Q. Did Susan Johnson ever complain to you about the fees on this transaction either before or after the closing?
A. After we closed.
Q. And what did she discuss with you? Do you recall that conversation?
A. She had thought that the fees were high.
Q. And what did you tell her?
A. I told her the fees are what the fees were for your type of transaction.
Q. Are there -- were there particular fees on the HUD 1 statement that you discussed with her?
A. Not that I recall.

Q. Do you recall which fees she identified as being high?
A. I don't recall.
Q. So you can't tell me any of the fees which she disputed with you?
A. I don't recall what her complaint was.
Q. Do you have any notes of your conversations with Ms. Johnson?
A. No.
Q. The good faith estimate that we spoke about earlier, that was given to the Johnsons prior to the time you locked in their loan?
A. Yes.
Q. What fees were on that document?
A. I don't recall. It should have been -- you know, I mean, there are standard fees. Prior to locking it in we didn't know which investor we were going to go with. So until we lock in, at the time we lock in we send them out another good faith estimate with that particular investors fees or the breakdown -- at that point we know what we need to make on the loan.
Q. How do your fees differ, yours meaning Allstate's -- I'll ask again. How do Allstate's fees differ depending on which lender funds the loan

whether it's -- that is whether it's ABN AMRO or Wells Fargo or Temple Inland or Chase or whoever?
A. Our fees don't differ. Our fees differ based on the type of transaction that we're doing.
Q. And how do they differ?
A. More difficult loan there is more fees that are incurred.
Q. And when do you make those determinations?
A. When we're in the process of the loan.
Q. Going back to line 808, that $1,620 which ABN AMRO paid to you, what does that term POC mean?
A. Paid outside of closing.
Q. What does that mean?
A. Means it was paid outside of closing.
Q. In what way?
A. I don't know what you're asking here.
Q. Do they send you a check after the closing or do they wire money into your account?
A. The money -- the check is given to us through the title company.
Q. At the closing?
A. Yes.
Q. So West Title --

A. Disburses the funds.
Q. They cut a check for 1,620 to you?
A. Well, they cut a check for all of my fees in one lump sum.
Q. What did you discuss about that deferred premium with the Johnsons?
A. I don't recall.
Q. Do you recall discussing anything about it with them?
A. When we were at the closing I assumed that we have all disclosed it to them that that's a fee that's outside of the transaction that they're not obligated to pay, I mean, out of their closing costs.
Q. Is it your opinion that fee has nothing to do with the Johnsons, with the borrower, the deferred premium?
MR. MACLIN: Object to the form.
MR. HERTZ: Object to the form.
THE WITNESS: Once again, I mean, we determine how much we need to make to do the loan. The Johnsons had a very difficult loan. That was part of the fee.
BY MR. ROBINOVITCH:
Q. My question was is it your position

that that fee had nothing -- that premium had nothing to do with the Johnsons?
MR. HERTZ: Objection to the form of the question.
THE WITNESS: As I'm saying, and maybe I'm misunderstanding what you're asking, but all of these fees was part of the total compensation. That's part of what the Johnsons paid.
BY MR. ROBINOVITCH:
Q. What role did the Johnsons play at the time which you locked in their interest rate at the above par rate of 7.5 percent, what role did they play in the agreement between you and AMRO to transfer that 1,620?
MR. MACLIN: Object to the form.
MR. ROBINOVITCH: I'll ask it again. Try to clarify the question.
BY MR. ROBINOVITCH:
Q. What role did the Johnsons play in the decision to receive a premium of 1,620 from ABN AMRO?
MR. HERTZ: Objection to the form of the question.
THE WITNESS: What do you mean what role did they play? I don't understand.

BY MR. ROBINOVITCH:
Q. Did they play -- let me ask it this way: Did they play any role in the decision to receive that premium?
A. They agreed to lock in at 8.75.
Q. But you never told them that was an above par rate I think is what you told me earlier; is that right?
A. That's correct. That was the rate that it would take to do their transaction as part of the total compensation.
Q. Prior to the closing you never discussed that premium with them did you?
A. No, I did not.
Q. And they didn't owe you an additional $1,620 did they?
MR. HERTZ: Objection to the form of the question.
MR. MACLIN: Objection to the form.
MR. HERTZ: I'm sorry. Go ahead.
BY MR. ROBINOVITCH:
Q. You can answer.
A. Ask the question again, please.
Q. They didn't owe you $1,620 did they?
A. To do this transaction that's how much

I needed to make. And that 1,620 was part of that, part of the fees that I incurred to make this loan happen.
Q. Did you ever send the Johnsons some type of bill for $1,620 on top of the direct fees which they paid to Allstate directly at the closing?
A. Never sent them a bill.
Q. Was there any type of other type of invoice or statement or any other type of document whatsoever that indicated to the Johnsons at any time prior to May 23, 2000 that they somehow owed Allstate an additional $1,620 on top of all the direct fees they were paying already, the origination fee, the discount fee, commitment fee, administration fee, et cetera?
A. There was never a bill sent, no.
Q. Do you receive deferred premiums on all transactions which you act as a broker on?
A. It depends on the transactions.
Q. What percentage of transactions where you're a broker would you say that you receive a deferred premium?
A. In most cases it's part of the compensation package.
Q. In most cases?

A. Yes.
Q. Can you give me an approximate number of transactions that your company deals with that involve some type of premium from the lender to Allstate?
A. Most cases.
Q. Would it be more than 90 percent of the loans?
A. That's hard to make that determination.
Q. Would it be more than 75 percent?
A. Once again, it's hard for me to make that determination.
Q. The best you can say is it's most transactions?
A. It's most transactions.
Q. Okay. At the beginning of the deposition today you told me that it's your position that you sold the Johnson's loan to ABN AMRO. Do you recall that?
A. That might have been a term I used.
Q. Is it your position that you sold ABN AMRO a funded, closed loan?
A. No. We delivered a loan to AMRO but we didn't sell a loan to them.
Q. In your discussions with the Johnsons

subsequent to the May 23 closing when Ms. Johnson was disputing the fees, did you ever discuss the deferred premium at that point with her?
A. What would the date be that you're asking?
Q. After the closing. After May 23.
A. Not to my knowledge, no.
Q. So you've never discussed the premium with her after the closing or before the closing?
A. I do not believe so, no.
Q. Okay. I just want to get some further clarification from you on the manner in which ABN AMRO's rate sheet was used to calculate that 1,620 premium. For the 30-year fixed loan product that they obtained, is it true that there is some type of matrix on the rate sheet that indicates a par rate and as rates rise above the par rate the premium that will be paid increases as well?
A. Plus the term of the lock, the length of time that you lock the loans, yes.
Q. How does the length of the lock affect the --
A. The longer the term of the lock the higher the interest rate.
Q. If you're dealing with the same lock

terms, say a 30-day lock, would it be true that as the interest rate rises above the par rate the size of the premium ABN AMRO will pay to your mortgage broker company increases proportionately?
A. Uh-huh.
MR. MACLIN: Object to the form.
MR. ROBINOVITCH: You can answer.
THE WITNESS: Yeah. If I understood your question right, yes.
BY MR. ROBINOVITCH:
Q. Other than the length of the lock and the interest rate, what other types of factors affect the size of the premium which you may receive from ABN AMRO?
A. I don't understand what you're asking.
Q. Are there any other factors that affect the size of a premium other than interest rate and the length of the lock term?
A. No, not to my knowledge. But I don't know -- I guess I don't know what you're asking.
Q. Does the size of the loan --
A. Yes.
Q. Affect the --
A. It needs to be over a hundred thousand. Loan amount. So based on a hundred thousand. If

communicates any distinction between the company called Interfirst and ABN AMRO?
A. Just the closing documents that everything is ABN AMRO Mortgage Group.
Q. But other than the closing documents on a loan you might work on, it's your understanding that -- well, strike that. Trying to rephrase it. Other than closing documents, you've never received any type of written communication indicating any distinction between the company called Interfirst and the company called ABN AMRO?
A. Not to my knowledge, no.
Q. Do you recall ever receiving anything, any type of written communication or document from Interfirst saying that the company will now be called ABN AMRO or anything like that?
A. Not to my knowledge, no.
Q. Show you what's been marked as Exhibit 7. Have you ever seen that document before?
A. Yes.
Q. You have seen that before?
A. Yes.
Q. Do you have all of the items in a separate loan file for the Johnsons that would be able to gather and copy, to produce to our office

pursuant to that request?
A. Not all of these -- not all of these are -- I could give to you because I don't receive the documents myself. I don't get a copy of the mortgage, the note, the deed. I don't get copies of any of that.
Q. Whatever you posses in your office --
A. Whatever I possess --
Q. -- you would be able to copy that relatively easily and produce to us?
A. Yeah.
Q. A few more questions, Mr. Schultz, and I'll be done. Going back just to the rate sheet that we were discussing a few minutes ago where you just -- you informed me that for loan interest rates above the given par rate on ABN AMRO's rate sheet there is a direct relationship between the size of the premium and the interest rate as it rises above par. Do you recall that?
MR. MACLIN: Object; lack of foundation.
BY MR. ROBINOVITCH:
Q. Do you recall that?
A. Yeah.
Q. Do you ever give AMRO's rate sheet to

the borrower prior to the closing?
A. If they happen to be in office we'll have the rate sheet there when we lock them in, but. . .
Q. I believe you told me you did not give the rate sheet to -- ABN AMRO's rate sheet to the Johnsons?
A. That is correct.
Q. Did you give them anything else, any other document which showed that direct relationship between the above par interest rate and the size of the premium ABN AMRO would pay to Allstate?
A. No.
Q. So there was no other document --
A. Not to my --
Q. -- that was given to the Johnsons showing that direct relationship between the above par rate and the size of the premium?
A. Not to my knowledge, no.
Q. Looking back on the HUD 1, that second page of the HUD 1, line 808 the deferred premium of $1,620. That premium didn't offset any fee that had been disclosed to the Johnsons, that's the Johnsons owing Allstate prior to the time you locked in their loan did it?

A. I don't understand what you're asking. Could you repeat?
Q. Sure. Looking at this deferred premium on line 8808, that $1,620 payment that Allstate received from AMRO, that didn't offset any fee that was specifically disclosed to the Johnsons in which the Johnsons were obligated to pay Allstate did it?
A. This was --
MR. MACLIN: Object to the form.
MR. HERTZ: Same objection.
THE WITNESS: This is part of the total compensation.
BY MR. ROBINOVITCH:
Q. But my question was prior --
MR. ROBINOVITCH: Can you read back my question. I'm trying to clarify the question.
(Requested portion of the record was read by the reporter.)
BY MR. ROBINOVITCH:
Q. Prior to the date you locked in the Johnson's interest rate with ABN AMRO I believe you told me earlier that there was no document that you had provided them showing that they somehow owed you $1,620 on top of these other fees. Do you recall that?

A. There is a loan origination agreement that they signed that states that there might be some other fees or some other income.
Q. Was there anything specific that was ever given to the Johnsons that showed that they owed you $1,620 on top of each of these other fees that they paid directly?
A. Not that exact dollar amount, no.
Q. You have a signed loan origination agreement with the Johnsons?
A. Correct.
Q. And that's in the file?
A. Yes.
Q. And what was the total fee that was agreed to in that agreement?
A. There wasn't a total fee that was entered into there. It was 1 percent loan origination fee. The loan origination agreement discloses that we will charge 1 percent loan origination and that other fees or other premiums might be paid to us.
Q. Did you --
A. Or by them.
Q. In that agreement did you explain that the loan origination fee is the same as a loan

discount fee that Allstate will charge in the same as a processing fee that Allstate will charge and the same as a commitment fee that Allstate will charge and the same as an administration fee that Allstate will charge?
MR. HERTZ: Objection; document speaks for itself.
THE WITNESS: Specifically, no. I mean, it's all the verbiage on the document.
BY MR. ROBINOVITCH:
Q. So your agreement disclosed the 1 percent loan origination fee but it did not disclose that there is a number of other fees that are the same --
A. That's what --
Q. -- as the loan origination fee?
A. That's what the good faith estimate would have showed them.
Q. When did you give them the first good faith estimate?
A. We mail it out within three days of taking the application.
Q. And going back to line 808 that deferred premium, did that offset any specific fee that you specifically disclosed to the Johnsons in

which the Johnsons were obligated to pay you? You Allstate?
MR. MACLIN: Object to the form.
MR. HERTZ: Same objection.
THE WITNESS: It was all part of the complete compensation package.
BY MR. ROBINOVITCH:
Q. But my question was did that premium offset a specific fee that was disclosed to the Johnsons prior to the time you locked in that rate and which the Johnsons were specifically obligated to pay you?
MR. MACLIN: Object to the form, asked and answered.
MR. HERTZ: Objection. Same objection as to asked and answered.
THE WITNESS: It's all part of the total premium package. I don't understand what the question you're asking.
BY MR. ROBINOVITCH:
Q. My question is: Is there a specific fee that the Johnsons owed you that that premium specifically offset and which fee was disclosed to the Johnsons?
MR. MACLIN: Just continuing objection

to this line of questioning.
MR. HERTZ: Same continuing objection.
THE WITNESS: I don't understand what you're asking me.
BY MR. ROBINOVITCH:
Q. What I'm asking you is: Is there a specific fee that that premium offset that the Johnsons owed you and which you disclosed to them?
MR. HERTZ: Objection; form of the question. Asked and answered.
THE WITNESS: No.
MR. ROBINOVITCH: Thank you. That's all I have. Thank you very much.
MR. MACLIN: Mr. Schultz, I have a few questions.

CROSS-EXAMINATION

BY MR. MACLIN:
Q. My name is Alan Maclin. I represent Standard Federal Bank. Mr. Robinovitch asked you at the outset, but we had never met before we both arrived here at the Zimmerman Reed office for the deposition today; correct?
A. That's correct.
Q. And you haven't talked with any of my partners or other counsel for Standard Federal

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MR. ROBINOVITCH: And there's no reason to say it again.
MR. HERTZ: Well, I'm joining in.
MR. ROBINOVITCH: You can answer.
THE WITNESS: The question again?
MR. ROBINOVITCH: Can you just read it back?
(The requested portion was read by the reporter.)
THE WITNESS: What I did is I gave them an interest rate and that was part of our total compensation. If they didn't like the interest rate they could have went to any other investor.
BY MR. ROBINOVITCH:
Q. But to answer my question, did you ever tell the Johnsons that they owed you $1620 --
MR. SCHROEDER: Object --
BY MR. ROBINOVITCH:
Q. -- and that premium was somehow paid for?
MR. SCHROEDER: Objection to form, asked and answered.
MR. HERTZ: I join in the objection.

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THE WITNESS: No.
BY MR. ROBINOVITCH:
Q. And the Johnsons never told you that they were intentionally electing to have an above par interest rate in order to finance a fee of $1620 that they otherwise would have owed your firm, your company, in cash, did they?
MR. SCHROEDER: Objection to form.
MR. ASHLEY: Object.
THE WITNESS: No.
MR. ROBINOVITCH: That's all I have at this time.
REEXAMINATION
BY MR. SCHROEDER:
Q. Mr. Schultz, my turn again. A couple of follow-up matters. One of the reasons that you and Allstate decided to use ABN AMRO on the Johnson first mortgage was because of their ability and willingness to fund that mortgage loan in light of Mr. Johnson's employment status?
MR. ROBINOVITCH: I'm going to object, leading, object to the form.
THE WITNESS: That was part of the reason.
BY MR. SCHROEDER:

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Q. And I believe in answer to either one of Mr. Hertz' questions or one of Mr. Robinovitch's questions you testified that the compensation paid to Allstate by ABN AMRO which I think was described as a yield spread premium that was part of your total compensation on this transaction?
A. That's correct.
Q. Would you have been able to perform your services in originating and processing the Johnson mortgage loan without the lender paid compensation from ABN AMRO?
MR. ROBINOVITCH: Object to the form.
THE WITNESS: No.
MR. SCHROEDER: Your answer?
THE WITNESS: No.
MR. SCHROEDER: I have no further questions.
MR. HERTZ: I've got some follow-through questions.
REEXAMINATION
BY MR. HERTZ:
Q. Mr. Schultz, I think you've already described that there was another document or

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contract entered in regarding the -- at closing the settlement statement; is that correct?
A. That's correct.
Q. And the Johnsons signed that contract?
A. Correct.
Q. All right. And additionally you sent them another contract, the good fifth estimate; is that correct?
A. Along with the truth in lending.
MR. ROBINOVITCH: Object to form.
BY MR. HERTZ:
Q. I'm sorry. Along with what?
A. Along with the truth in lending.
Q. All right. And describe the truth in lending real quickly. What does it disclose?
MR. ROBINOVITCH: Object to your characterization of contract.
BY MR. HERTZ:
Q. What does it disclose?
A. At the time of application what interest rates we talked about, programs we talked about. It just discloses the interest rate and what the APR would be.
Q. Did you throughout any of the

PREPARED STATEMENT OF HOWELL E. JACKSON

FINN M.W. CASPERSEN AND HOUSEHOLD INTERNATIONAL PROFESSOR OF LAW AND ASSOCIATE DEAN FOR RESEARCH AND SPECIAL PROGRAMS
HARVARD UNIVERSITY SCHOOL OF LAW

JANUARY 8, 2002

Chairman Sarbanes and Members of the Committee, I am very pleased to be here today to discuss the problem of yield spread premiums and the Department of Housing and Urban Development's recent Statement of Policy 2001–1, 66 Fed. Reg. 53,052 (Oct. 18, 2001) (Statement of Policy). Yield spread premiums and related industry practices have become a major problem for American homeowners. Payments of this sort are inherently confusing and serve primarily to raise the cost of homeownership for many Americans, particularly the less educated and the financially unsophisticated, by billions of dollars a year. In my opinion, yield spread premiums represent the sharp practices that Congress should have prohibited when it enacted the Real Estate Settlement Procedures Act of 1974 (RESPA) more than 25 years ago. I urge both Congress and the Department of Housing and Urban Development to redouble their efforts to eliminate the substantial and widespread consumer abuses that yield spread premiums have visited upon American homeowners in recent years.

Introduction

Over the past year, I have been investigating the economic impact of yield spread premiums.[1] A major component of my investigation has been an empirical analysis of a nationwide sample of approximately 3,000 mortgages originated by one group of affiliated lending institutions in the late 1990's. This study constitutes the most extensive empirical investigation of yield spread premiums to date. In my testimony before the Committee this morning, I would like first to discuss the implications of my study for the Department's policy statement and then to propose a number of specific actions I believe the Department should take to prevent abusive uses of yield spread premiums in the future.

The Policy Statement

Let me begin by commending the Department for its willingness to take on an issue as complex as the payment of yield spread premiums. While my analysis of these practices differs from the Department's views in many important respects, I wholeheartedly agree with the Department's initial premise and the premise of the RESPA itself: That real estate settlement practices are an area in which governmental intervention is necessary both to protect consumers and to ensure the efficient operation of market forces.

My comments about the policy statement are divided into two parts. First, I will discuss the statement's factual assumptions about the role of yield spread premiums in today's mortgage market. Second, I will comment on several aspects of the Department's legal analysis of how Section 8 of RESPA, which prohibits certain kickbacks and unearned referral fees, should be applied to the payment of yield spread premiums.

FACTUAL ASSUMPTIONS ABOUT THE ROLE OF YIELD SPREAD PREMIUMS

As explained in the policy statement, the Department conceives of yield spread premiums as a valuable "option" that "permits homebuyers to pay some or all of the upfront settlement costs over the life of the mortgage through a higher interest rate."[2] This method of financing upfront settlement costs, according to the Department, is particularly suited to borrowers who are low on cash and "whose loan-to-value ratio has already reached the maximum permitted by the lender."[3] Based on these factual assumptions, the Department concludes that the yield spread premium is a "legitimate tool to assist the borrower" and a financing option that "fosters homeownership."[4]

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[1] I initially undertook this project as an expert for the plaintiff class in *Glover* v. *Standard Federal Bank,* Civil No. 97–2068 (DWF/SRN) (U.S. District Court, District Court of Minnesota) (pending) and am currently expanding the study into an academic article, the current draft of which is attached to this testimony: Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (January 8, 2002) (hereinafter "Jackson & Berry") [a abridged draft of this paper is available at *http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.*

[2] 66 Fed. Reg. at 53,054.

[3] *Id.*

[4] *Id.*

As a purely theoretical matter, the Department's assumptions about the role of yield spread premiums are plausible. Homeowners who are short on cash could, theoretically, use yield spread premiums to finance settlement costs. My study, however, offers compelling evidence that yield spread premiums are not being used in this way.[5] Rather, the manner in which yield spread premiums are levied combined with the complex structure of real estate settlement procedures serves principally to allow mortgage brokers to impose higher prices on borrowers who bear the cost of these charges—particularly on individuals who are less educated and less sophisticated about financial matters. This abusive form of price discrimination substantially increases the overall costs to borrowers, thereby imposing a hidden tax on homeownership for many Americans.

Yield Spread Premiums Are Not Currently Presented to Consumers as an Optional Way to Finance Settlement Costs

An initial problem with the Department's understanding of yield spread premiums is its notion that these payments represent an option consumers voluntarily choose. Consumers are given no such choice. Mortgage brokers, in my experience, never describe yield spread premiums as an optional method for financing settlement costs, nor do the Department's own consumer publications or the most popular consumer guides for buying a home. What is more, consumers are never given the advice they would need to make a meaningful comparison between the cost of higher interest rates over the life of a loan and direct cash payments for closing costs.[6] Rather, borrowers are simply told that their loans will have a certain interest rate, and they never understand that the interest rate is higher than it needs to be or that the higher interest rate is used to finance a payment to the mortgage broker.

Incidence and Magnitude of Yield Spread Premiums Are Extremely High

Another erroneous factual assumption implicit in the policy statement is the notion that yield spread premiums are paid by a relatively small number of borrowers who lack adequate resources to pay closing costs directly. To the contrary, my study indicates that the vast majority of borrowers pay yield spread premiums—on the order of 85 to 90 percent of all transactions.[7] Moreover, the average amount of yield spread premiums is quite substantial, on the order of $1,850 per transaction, making these payments the most important single source of revenue for mortgage brokers.[8] In other words, contrary to the Department's assumptions, yield spread premiums are not an "optional" form of financing made available to a limited number of borrowers with special needs. Rather these payments constitute by far the largest source of compensation for mortgage brokers and are imposed on almost all borrowers who obtain mortgages or refinancings through this segment of the industry.

Most Borrowers with Yield Spread Do Not Need Extra Financing

Another fallacy in the Department's factual assumption is its suggestion that borrowers who pay yield spread premiums have no other means of paying closing costs. This assumption is clearly wrong. According to my analysis, more than three-quarters of the borrowers who were charged yield spread premiums had loans that were

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[5] As indicated above, the sample upon which my empirical study is based was limited to loans originated by an affiliated group of lending institutions and thus does not include loans from all lending institutions in the industry. It is possible that the abusive practices uncovered in my study are peculiar to the lending institutions included in my sample. However, I doubt that this is the case. Industry experts have opined that the practices of the lenders in my study "are typical of other wholesale lenders." See Report of David Olson, *Glover* v. *Standard Federal Bank,* Civil No. 97–2068 (DWR/SRN) (U.S. District Court, District Court of Minnesota) (filed June 24, 2001) (expert for defendants). At a minimum, the evidence uncovered in my study should put the burden on the Department to demonstrate with comparable evidence that the factual assumptions underlying the policy statement are accurate for the industry generally.

[6] What HUD regulations do require is "disclosure" of yield spread premiums. However, this disclosure is inadequate in many respects. Yield spread premiums are not reported in a consistent manner in HUD–1 forms; oftentimes they appear on back pages of the form and sometimes in a smaller font. Most important, these payments are almost always denominated "p.o.c. by lender," meaning that they are "paid outside of closing by the lender." It is inconceivable that more than a tiny fraction of consumers can correctly evaluate this information. For a more complete discussion of the problems consumers face in deciphering this information, see Jackson & Berry, *supra* note 1, at 2–5, 51–65.

One measure of inadequacy of current disclosure practices is the difficulty my assistants had even finding the amount of yield spread premiums on HUD–1 forms. Even after receiving explicit training on the subject, a team of paralegals and certified public accountants was only able to find yield spread premiums on about two-thirds of the forms on which the payments were supposedly disclosed. See Jackson & Berry, *supra* note 1, at 71–74 & n.112.

[7] See Jackson & Berry, *supra* note 1, at 73 (Table 2).

[8] *Id.* at 78–81.

less than the defendant lending institutions' maximum loan-to-value ratios and therefore could easily have financed closing costs by increasing the amount of their loans.[9] In other words, most borrowers who are charged yield spread premiums do not need an extra (and exorbitantly costly) form of financing for their closing costs.

Mortgage Brokers Earn on Average $1,046 More on Loans With Yield Spread Premiums

Another erroneous premise of the policy statement is that industry offers yield spread premiums as a service to their customers and is indifferent to whether consumers pay closing costs directly or through the imposition of yield spread premiums. Mortgage brokers clearly much prefer making loans with yield spread premiums. According to my study, mortgage brokers made an average of $1,046 more on loans with yield spread premiums than they did on comparable loans unaffected by these practices.[10] Thus, on average, borrowers who get loans with yield spread premiums pay their mortgage brokers over a thousand dollars more than other borrowers. This substantial difference, in my view, goes a long way to explain why the industry has so zealously resisted efforts to police the payment of yield spread premiums, and it clearly refutes the Department's premise that yield spread premiums are just another form of payment.[11]

On Average, Seventy-Five Percent of Yield Spread Premiums Goes to Mortgage Brokers

The most critical error in the policy statement is its assumption that mortgage brokers use yield spread premiums to "recoup the upfront costs incurred on the borrower's behalf."[12] In my study, I employed a variety of statistical techniques to explore the relationship between yield spread premiums and direct cash payments to mortgage brokers. With the highest degree of statistical confidence, my studies refute the proposition that borrowers receive a dollar for dollar offset for yield spread premiums.[13] My best estimate is that borrowers, on average, enjoy 25 cents of benefit for each dollar paid in yield spread premiums.[14] In other words, the vast majority of yield spread premiums—on the order of seventy-five percent—serve only to increase the compensation of mortgage brokers. Contrary to the Department's assumptions, consumers do not, by a long stretch, recoup the costs of yield spread premiums.

Characterized as a Form of Financing, Yield Spread Premiums Are Usurious

As explained above, I do not believe that yield spread premiums are actually being offered to borrowers as a form of financing upfront costs.[15] However, if one were to accept this characterization and then attempt to estimate the cost of this financing, the implicit interest rates are absolutely outrageous. For an average borrower in my study, the implicit interest rate on a "yield spread premium loan" to finance closing costs would be in excess of 114 percent per year—on the order of ten times higher than a typical credit card interest rate.[16] Had the Department been aware of the true costs of this financing when it prepared its policy statement, I expect it would have approached the problem in a very different manner.

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[9] *Id.* at 147 & n. 180. My study did not consider other sources of funding, such as cash reserves or credit cards or loans from family members. Were these and other alternative sources considered, even more borrowers would have had viable financing options other than paying yield spread premiums. As explained below, the true costs of yield spread premiums are so high that a borrower would be well advised to employ almost any other form of financing.

[10] *Id.* at 91–97 (Figure 14).

[11] Why mortgage brokers can earn more money on loans with yield spread premiums is an interesting and important academic question. I explore this issue in considerable detail in my academic writings on the subject. In brief, I believe a number of factors are at work. In this context, consumers are primarily concerned with buying homes and being approved for financings; thus, they spend less time monitoring the comparatively smaller costs associated with real estate settlement. In addition, they trust their mortgage brokers to recommend appropriate financing terms and cannot easily police these recommendations. In addition, consumers have difficulty calculating costs of higher monthly payments as compared with direct cash payments and are not protected by market forces because these side payments allow brokers to discriminate among sophisticated an unsophisticated consumers and avoid creation of a single market price for settlement services. See *Id.* at 51–65.

[12] 66 Fed. Reg. at 53,054.

[13] Jackson & Berry, *supra* note 1, at 102–16.

[14] *Id.*

[15] *See supra* text accompanying note 6.

[16] Jackson & Berry, *supra* note 1, at 144–47.

African-Americans and Hispanics Pay Much More for Mortgage Broker Services

While my study suggests that yield spread premiums are a very bad deal for the average consumers, I believe these practices are particularly injurious to the least sophisticated members of society—groups of which the Department has historically been most protective. To test this hypothesis, I also examined the relationship between mortgage broker compensation and the racial identity of borrowers. The results indicated that mortgage brokers charged two racial groups—African-Americans and Hispanics—substantially more for settlement services than they did other borrowers. For African-Americans, the average additional charge was $474 per loan, and for Hispanics, the average additional charge was $580 per loan.[17] While I expect to do more work on this aspect of my analysis, these preliminary results are consistent with my hypothesis that current industry practices allow mortgage brokers to exploit less sophisticated borrowers by imposing higher charges.

LEGAL ANALYSIS PROPOSED IN THE POLICY STATEMENT

The Department's misapprehension of the true economic impact of yield spread premiums has substantial implications for the policy statement's legal analysis. Had the Department understood how disadvantageous yield spread premiums are for most consumers, the Agency would, I believe, have proposed that the payments be treated very differently under the two-step test used to determine whether particular payments are prohibited under Section 8 of RESPA.[18]

Payment of Yield Spread Premiums Could Run Afoul of the First Step of HUD's Test

In its policy statement, the Department summarily concludes that yield spread premiums are paid for "goods or services" and thus reasons that the payments passed the first step of the Department's test. If one accepts the Department's factual assumptions—that yield spread premiums are a *bona fide* option for financing closing costs and that the payments are in fact recouped through offsetting reductions in closing costs—this conclusion would be understandable. However, if instead one credits the findings of my study—that the yield spread premiums serve primarily to increase payments to mortgage brokers and not to lower the upfront costs of borrowers—the legality of the payments under step one of the HUD test is far from clear. As explained above, my study suggests that only a fraction of each dollar of yield spread premiums goes to financing goods and services. Under these circumstances, I believe that it is more accurate to characterize the payment of yield spread premiums as *not* being a *bona fide* payment for goods and services. Under this view, the practice runs afoul the first step of the Department's test for legality.

Allowing Payments of This Sort To Escape Liability Under Step One Does Not Square With the Congressional Policies Underlying Section 8 of RESPA

The alternative approach—that is, allowing settlement service providers to escape liability under step one as long as the providers could show they contributed some value to the transaction—flies in the face of the legislative history that preceded the passage of RESPA. In the early 1970's, real estate settlements were plagued by kickbacks and referral fees. Typically, a firm with substantial influence over the settlement—for example an attorney or a real estate agent—would demand sidepayments from other service providers, such as title insurance companies, as a *quid pro quo* for recommending the service provider to preform the transaction. It was these referral fees that Congress should outlaw with Section 8 of the RESPA, principally because Congress believed these transactions increased the overall cost of homeownership.[19] Were the Department to adopt the position that recipients of kickbacks have a defense from Section 8 liability if they can demonstrate that they provided some other goods or service for the transaction, it would seem to have created a major loophole for just the kinds of sharp practices that the provision was designed to eliminate. After all, almost all of the recipients of kickbacks that motivated the passage of the Act also performed some level of service for the settlement transactions in questions. Certainly, where statistical evidence demonstrates that the payments in question (here yield spread premiums) serve substantially—indeed

[17] *Id.* at 120–26. This analysis controls for a variety of factors, including principal loan characteristics, credit quality of borrower, loan-to-value ratios, and certain geographic variables.

[18] In an earlier statement of policy, the Department proposed this two-step test. Under the first step, courts are to consider whether a particular payment is made for "goods and services actually furnished or services actually performed." If the answer to this question is no, then liability is attached; if the answer is no, then the court must proceed to the second step of the test, under which it must determine whether the amount of the payment was reasonably related to the goods and services provided. See HUD Statement of Policy 1999–1, 64 Fed. Reg. 10,080 (March 1, 1999).

[19] *Id.* at 9–23.

primarily—to increase the cost of homeownership, the activity should be proscribed under Section 8.

Inappropriateness of Individualized Adjudication of Reasonableness

A further difficulty with the Department's legal analysis is its apparent willingness to have the courts determine the reasonableness of yield spread premiums on a case-by-case basis. As this aspect of the policy statement concerns a matter of judicial management, it is a matter that the courts themselves will have to resolve. But, on multiple dimensions, individualized determinations of reasonableness of the sort the Department appears to favor would be problematic. To begin with, in order to measure the impact of yield spread premiums for a particular borrower, a court must consider the impact of the payments in a large number of cases, as I did in my study. As is well-developed in other areas of the law—ranging from disparate impact cases to securities litigation—it is impossible to assess the reasonableness of one borrower's payments in a vacuum. For both litigants and courts, it would be an inefficient use of resources to repeat this analysis on a transaction by transaction basis. In addition, the Department's approach invites the judicial rate regulation that Congress expressly rejected when it enacted RESPA more than 25 years ago. In the early 1970's, many recommended ratemaking procedures for real estate settlement services, but Congress chose instead to police the industry through a combination of disclosure rules and the liability provisions of Section 8. The policy statement threatens to resurrect judicial rate regulation as the principal mechanism for controlling kickbacks in the real estate settlement field. Arguably, under the Department's approach, a Section 8 plaintiff would be forced to sustain the costs of a hearing on reasonableness whenever a defendant demonstrates that it provided any goods or services in connection with a settlement. In my view, this approach subverts the intentions of Congress and leaves consumers inadequately protected from predatory practices, such as the payment of yield spread premiums. Moreover, the approach seems to relieve from liability many of the abusive practices that Congress intended to outlaw with the enactment of Section 8.

Proposals for Prospective Relief

One of the most heartening aspects of the policy statement is the Department's willingness to propose changes in the disclosure rules regarding yield spread premiums and related practices. In my view, reforms in this vein could go a long way toward protecting consumers and improving the efficiency of the market in this area. In particular, I would recommend the following specific changes.

Requiring Disclosure of Par Rate Loan Option

One of the principal sources of confusion underlying yield spread premiums is that most consumers are not aware that when they are offered an above-par loan (on which a yield spread premium is paid), they almost always have the option of receiving a par rate loan with a lower interest rate and lower monthly payments. Whenever a mortgage broker proposes an above-par loan, the Department should therefore require the broker to offer the borrower a comparable loan with a par interest rate. By offering consumers both types of loans, mortgage brokers would make clear that above-par loans (and yield spread premiums) are simply one option for home financing.[20] Requiring such offerings would also encourage both the Department and independent consumer groups to educate consumers about the pros and cons of the two options.

Direct Payment of Yield Spread Premiums to Consumers (on Line 200)

Whenever a mortgage broker presents a Good Faith Estimate or a HUD–1 form for an above-par loan, the full amount of the yield spread premium should be paid directly to the borrower in the form of a credit on line 200. If yield spread premiums are to become a legitimate form of financing, the proceeds of the financing must always be given to the borrower. Then, the borrower can decide how to use those funds—whether to pay for closing costs or some other purpose. A further advantage of this reform is that it will force mortgage brokers to provide borrowers with a full accounting of their costs elsewhere on the form. Under the current rules, brokers use yield spread premiums to disguise their true levels of compensation. Not only is the current practice inherently deceptive; it also makes it all but impossible for consumers to compare the true costs of loans from different brokers and lenders.

[20] Brokers might also be required to disclose the rate sheet associated with the pricing of their loans. This would provide more information than most consumers would need but could be useful to consumer groups and the financial press.

Prohibition on Discount Points Paid to Brokers

A further practice that should be eliminated is the payment of discount points to mortgage brokers. Traditionally, consumers pay discounts points to lenders in order to obtain a below-par loan—that is, a loan with an interest rate below the rate on a comparable par loan. Under current HUD regulations, however, mortgage brokers are also permitted to charge discount points "to lower" the interest rate of a loan. In my study, I discovered that mortgage brokers were routinely charging discount points, even on par and above-par loans.[21] This practice is inherently deceptive. The only way a mortgage broker can "lower" the interest rate on such loans is to start by offering the borrower an above-par rate. In this context, the payment of discount fees to mortgage brokers simply serves to convert a yield spread premium into a direct upfront cost for the borrower.[22] In my view, the term "discount fees" should be limited to payments made to the lending institution that are actually used to lower a par rate loan into a below-par loan.

Comparable Reforms for Direct Lenders

A final area of regulatory reform concerns the development of comparable disclosure requirements for direct lenders. Representatives of mortgage brokers occasionally defend current disclosure practices on the grounds that reforms of the sort outlined above would put mortgage brokers at a disadvantage to direct lenders. The Department, I believe, should reject claims of this sort. To begin with, mortgage brokers have become the leading source of home mortgages in the United States. It is imperative that the Department correct disclosure practices for this dominant segment of the industry. To allow issues associated with other sectors of the industry to stand in the way of such reforms would be letting the tail wag the dog. Still, I agree with those who say that disclosure reforms for direct lenders are also appropriate. After all, when direct lenders charge above-par rates and then resell their loans in the secondary market, they receive implicit yield spread premiums. The solution to this problem, I believe, is to require direct lenders to credit borrowers with an implicit yield spread premiums similar to the ones to be required for mortgage brokers. For direct lenders who actively participate in the wholesale purchase of loans, the appropriate par rates could be derived from the institution's contemporaneous rate sheets. For other direct lenders, the Department might maintain and keep current a national listing of averages of par rates for various categories of loans, derived from the contemporaneous rates sheets of leading wholesalers. The Department would have to work out the details of such a proposal, but the concept is well within the Agency's expertise.

Let me conclude by again commending the Department for taking on this issue. I would be delighted to work with the Department as it moves forward in this area, and would welcome any questions that Members of the Committee have.

PREPARED STATEMENT OF JOHN COURSON

CHAIRMAN-ELECT, MORTGAGE BANKERS ASSOCIATION AND
PRESIDENT AND CHIEF EXECUTIVE OFFICER, CENTRAL PACIFIC MORTGAGE COMPANY
FOLSOM, CALIFORNIA

JANUARY 8, 2002

Good morning Mr. Chairman and Members of the Committee. My name is John Courson, and I am President and CEO of Central Pacific Mortgage Company, headquartered in Folsom, California. I am also Chairman-elect of the Mortgage Bankers Association of America (MBA),[1] and it is in that capacity that I appear before you today.

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[21] The incidence of discount fees to mortgage brokers ranged from 10 percent to 47 percent, depending on the sample, and averaged between $744 and $1,335. See *Id.* at 77 (Table 4).

[22] Not only does this practice needlessly complicate the true compensation of mortgage brokers; but it also belies claims that above-par loans are being used to lower upfront costs for consumers. How could a consumer rationally request an above par loan for this reason and then pay an upfront discount fee to turn the loan back into a par loan?

[1] MBA is the premier trade association representing the real estate finance industry. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation's residential and commercial real estate markets, to expand homeownership prospects through increased affordability, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate professionals through a wide range of educational programs and

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This morning I have been asked to testify before your Committee to present MBA's views regarding the issue of lender payments to mortgage brokers, generally referred to as "yield spread premiums," and how they are to be judged under the antikickback provisions of the Real Estate Settlement Procedures Act (RESPA). To ensure a clear understanding of our position on this issue, it is important to lay the groundwork by defining the term "yield spread premium," and highlighting the important role that this financing tool plays in mortgage transactions.

Definitions

As a general rule, the term "yield spread premium" is used in the mortgage lending industry to refer to a type of payment from a lender to a mortgage broker, which is paid in the context of "brokered" loan transactions. In such transactions, mortgage brokers generally operate as intermediaries between consumers and lenders. In effect, they function as the interface with prospective borrowers, serving as the "storefront" for mortgage loan products offered by lenders. In this role, mortgage brokers are much more than "retailers" of loans; they perform real and valuable services in the origination phase of the mortgage transaction process. Among other things, mortgage brokers bring borrowers and lenders together and match consumer needs with lender products, they collect pertinent financial information, render advice to consumers, and generate all documentation and verification required for the loan transaction to occur.

It is important to clarify that, for the various goods, services, and facilities they provide in the origination of loans, mortgage brokers are entitled to be compensated. Generally, such compensation will occur in either of two ways. Brokers may collect their full compensation from the consumer directly, in the form of a cash payment. Alternatively, they can be paid, in part or in whole, indirectly by the lender, through the mechanism of a yield spread premium.

The yield spread premium mechanism works by allowing a consumer to choose a higher interest rate in exchange for lower upfront costs. Under this financing tool, the higher interest rate allows lenders to tender an amount reflecting the value of that increased yield to mortgage brokers as compensation for the goods, services, or facilities that they render. In technical parlance, a "yield spread premium" is thus defined as a payment that a lender makes to a mortgage broker that reflects the increased yield over "par" on a particular loan. In practical terms, a yield spread premium is a mechanism that provides borrowers with a vital tool to allow for the financing of some or all of their home loan closing costs.

The yield spread premium mechanism allows mortgage brokers the flexibility to offer consumers numerous options and choices as to the combination of upfront payments and interest rates that best suits the borrower's individual needs. In short, as the interest rate goes up, the borrower's upfront cash contribution goes down. The added financial flexibility afforded by the yield spread premium is extremely important because a vast number of borrowers—especially those who have limited funds for downpayments, or who have reached borrowing limits—need the flexibility to finance the required closing costs to achieve homeownership. Those consumers who lack sufficient independent funds literally depend on the YSP option to purchase and/or refinance a home.

I want to clarify, unequivocally, that the yield spread premium mechanism should be restricted to the function I just described, which is to compensate the broker for goods, services, or facilities provided or to allow for the financing of other closing-related costs. If, on the other hand, the yield spread payment does not fit this definition, and the payment is used for purposes other than to compensate brokers for the *bona fide* goods, services, or facilities they provide, or to finance other required closing costs, then the payment may be considered suspect, and should be dealt with appropriately. I want to make clear that we do not consider it appropriate to use the yield spread premium mechanism as a means to inflate interest rates in a way that defrauds the consumer into higher loan prices. Nor do we consider it appropriate to use the yield spread premium as a means of concealing referral payments to brokers. To the extent that such abuses do occur, they should be labeled for what they are—violations of the law.

HUD's Policy Statements

We are in agreement with HUD's formulation of the test for determining the legality of lender payments to mortgage brokers under RESPA. As you know, the rules for determining the legality of payments to mortgage brokers under RESPA's

technical publications. Its membership of approximately 2,800 companies includes all elements of real estate finance: Mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies, and others in the mortgage lending field.

antireferral fee prohibitions are set forth in a 1999 HUD policy statement,[2] and recently clarified through an additional statement published on October 18, 2001.[3] In those policy statements, HUD has explicitly acknowledged that yield spread premiums are very useful tools to assist consumers in financing homeownership. The policy statement clarifies that yield spread premiums, so long as they compensate the broker for goods, services, or facilities provided in the origination of a mortgage loan, are *not* in themselves illegal under RESPA. Under HUD's jurisdiction over RESPA's referral fee prohibitions, the policy statement and the subsequent clarification state *unequivocally* that yield spread premium payments are to be considered illegal if they constitute referral payments or if they incorporate referral fees in the payment. We agree.

HUD's formulation under Section 8 of RESPA correctly recognizes that the legal test for analyzing yield spread premiums (or other lender payments to mortgage brokers) must distinguish between those payments that are legitimate compensation to brokers, and those that are merely referral fees. In setting forth its formulation, HUD tracks the RESPA statute quite closely. As mentioned above, RESPA sets a strict prohibition against kickbacks and referral fees. The statute also states that payments for real goods or services are *not* prohibited. It is a simple and straightforward test. If you pay a referral fee, you are breaking the law. If, however, the fee is tendered as compensation for real goods, services, or facilities, then the payment cannot, by definition, constitute a referral fee or a kickback, and is therefore not prohibited under RESPA strictures.

This is precisely what HUD sets forth in the policy statement formulation. When a lender pays a fee to a mortgage broker, first, one has to lay the foundation and ensure that services, goods, or facilities were actually furnished by the mortgage broker. If services, goods, or facilities were actually furnished, then one has to make sure that the payment to the broker does not incorporate a referral fee portion that could be deemed illegal under RESPA. According to HUD, this is done by scrutinizing the total of broker payments to ensure that they are "reasonably related" to the value of the services, goods, or facilities furnished. Any amount over the "reasonable" level could be deemed to constitute a "referral fee." The "reasonableness" test is the test that HUD has consistently used to judge Section 8 liability in all circumstances since RESPA was enacted.

Note that this "two-prong test" strikes the best possible balance between RESPA's affirmation for fees paid as compensation for goods or services actually provided, and the statute's proscription of referral fees. Note also the internal logic of the HUD two-prong test—the first prong focuses on what the broker provides in the transaction, and the second prong analyzes the fees that were paid for those services. Each step is grounded on statutory language and each step is necessary to the legal analysis under Section 8 of RESPA.

HUD Clarifications

In large part, the controversy prompting today's hearing appears to be the recent clarification to the 1999 policy statement issued by the Department on October 18, 2001. In that clarificatory statement, the Department declared that it should eliminate certain ambiguities with respect to yield spread premiums.

The specific "ambiguity" that HUD should remedy stemmed from an appellate decision entitled *Culpepper* v. *Irwin Mortgage Corp.,* 253 F.3d 1324 (11th Cir. 2001) (Culpepper III). In that decision, the Eleventh Circuit Court of Appeals reached a decision that was in direct conflict with the "two-prong" formulation established by HUD under the 1999 policy statement. In that decision, the 11th Circuit described HUD's 1999 policy statement as "ambiguous" and created a new test that resulted in *per se* liability for the payment of yield spread premiums.[4]

In issuing the clarification, HUD was abiding by previous Congressional directives to articulate clear legal standards. In 1998,[5] Congress expressed concern about the "legal uncertainty" surrounding the test for liability in these cases, particularly in

[2] Real Estate Settlement Procedures Act Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers; Final Rule, 64 Fed. Reg. 10080–10087 (March 1, 1999).

[3] Real Estate Settlement Procedures Act Statement of Policy 2001–1: Clarification of Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b), 66 Fed. Reg. 53052–53059 (October 18, 2001).

[4] According to HUD, the *Culpepper III* decision results in *per se* liability through its conclusion that a jury could find that yield spread premiums are illegal kickbacks or referral fees where the lender's payments are based exclusively on the interest rate differentials reflected on the rate sheets and the lender has no knowledge of what services, if any, the broker performs.

[5] See Reform of the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA): Hearing Before the House Committee on Banking and Financial Services, 105th Congress at 22–28, 50, 275 (July 22 and September 16, 1998).

light of the fact that "Congress never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of [Section 8 of RESPA]."[6] Congress then specifically "direct[ed]" HUD to issue a "policy statement" in order "to clarify its position" and provide "guidance to . . . the courts."[7]

The 1999 policy statement thus represented HUD's Congressionally mandated effort to promote uniformity on the legality of yield spread premiums under Federal law. After the issuance of the 1999 policy statement, lenders and mortgage brokers, especially those who had faced years of costly litigation in these cases, justifiably relied on HUD's legal formulations as having finally eliminated litigable issues relating to the governing standard for liability. Indeed, district courts overwhelmingly agreed, and interpreted the 1999 policy statement to articulate the "two-prong test" that I described above.

The Eleventh Circuit's *Culpepper III* decision, however, shattered this legal clarity and returned the lending industry to the confusing legal environment that existed before 1999. By finding the 1999 policy statement "ambiguous," and articulating a legal test resulting in *per se* liability that was entirely separate from the one advanced by HUD, *Culpepper III* plunged lenders, brokers, consumers, and courts into the same chaotic state that led Congress to direct HUD to act in the first place. A new wave of over 40 yield spread premium RESPA nationwide class actions were filed in the immediate aftermath of *Culpepper III.* Over 80 class actions were still pending in district courts around the country, with a particularly heavy concentration in the Eleventh Circuit. The risk of inconsistent determinations based on the solitary Federal statute at issue in these cases was very real. In the meantime, several district courts outside the Eleventh Circuit were refusing to follow *Culpepper III's* RESPA liability analysis, and instead continued to accord deference to HUD's policy statements.[8]

I note that inconsistencies in the governing legal standard are extremely problematic for lenders. Most wholesale lenders make loans in a variety of geographic regions, and a large number of lenders have truly nationwide operations. There were many lenders who had already successfully defended prior RESPA challenges to their payment of yield spread premium, typically at costs ranging in the hundreds of thousands of dollars. Many of these same mortgage bankers began facing renewed litigation in the Eleventh Circuit where they were exposed to very different standards under the unique rules established by *Culpepper III.* This renewed legal confusion forced many national lenders to give serious consideration to halting or geographically limiting the practice of offering yield spread premiums, despite its admitted consumer benefits.

It is in the midst of this environment of legal turmoil that the Department decided to clarify RESPA through the 2001–1 policy statement. To reestablish clarity, HUD declared that it expressly "disagree[d] with the judicial interpretation regarding Section 8 of RESPA and the 1999 Statement of Policy" found in *Culpepper III.* 66 Fed. Reg. 53054–55. In the clarification, HUD sets forth its definitive reading of the law that neither Section 8(a) of RESPA nor the 1999 Statement of Policy supports the conclusion that a yield spread premium can be presumed to be a referral fee based upon the use of a rate sheet, or because the lender does not have specific knowledge of what services the broker has performed.

We believe that HUD acted properly and very responsibly as the regulatory agency that holds jurisdiction and bears the ultimate duty for the proper administration of RESPA. Absent HUD's clarification, the confused legal landscape would have been intolerable in terms of risk and legal exposure. Not only was the Eleventh Circuit's decision irreconcilable with HUD's reading of the law, but it threatened catastrophic industry liability, and also threatened to eliminate from the marketplace yield spread premiums and the critically important role they play in promoting homeownership.

Class Action

An additional criticism has been that the legal articulation in the 2001 policy statement cuts off the possibility of consumer redress under RESPA. The clarifications set forth in the 2001–1 Statement of Policy do not eliminate a single consumer's legal rights. In the 2001 policy statement, HUD asserts that, in order to determine whether yield spread premiums violate Section 8 restrictions, it is nec-

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[6] Conf. Rep. No. 105–769, *reprinted in* 1998 U.S.C.C.A.N. at 539, 568.

[7] *Id.*

[8] See *Bjustrom* v. *Trust One Mortgage Corp.,* No. C–001166P, 2001 U.S. Dist. LEXIS 17890 (W.D. Wash. October 26, 2001); *Vargas* v. *Universal Mortgage Corp.,* No. 01 C 0087, 2001 U.S. Dist. LEXIS 19635 (N.D. Ill. November 29, 2001).

essary to look at each transaction *individually.* Far from immunizing the industry, however, this ruling stems from HUD's longstanding recognition that the origination of mortgage loans, the specific services provided by mortgage brokers, and the difficulty of providing those services, all differ with each loan, each applicant, and each marketplace or geographical location.

In short, HUD's assertion that RESPA demands individualized loan-by-loan analysis of the level of services performed in relation to the fees paid does not reflect an attempt to relieve industry from liability. It reflects the reality, as recognized by every Administration since RESPA was enacted, that each transaction is different and contains unique features that requires varying levels of time, effort, and expertise.[9] Just as the consumer disclosures mandated by RESPA demand individualized disclosures reflecting the specific costs that relate to the specific loan transaction at hand, the analysis of legality under Section 8 of RESPA also demands a tailored examination of the goods and facilities provided or services performed by the broker in the transaction.

Additional Consumer Protections

As I mentioned above, we all recognize that there are instances where yield spread premiums are used in ways that could be harmful to consumers. We hear reports of consumers who pay egregious interest rates due in whole or in part to wildly inflated yield spread premium fees, or mortgage brokers that conceal yield spread payments in a way that leads to the consumer's detriment.

In this regard, we commend the Chairman in his leadership in holding these hearings, as such problems do require our full attention. We also commend the Department for its initiative to ensure that consumers receive full and meaningful disclosures in the mortgage process. In the 2001 policy statement, HUD has articulated the need to strengthen the information provided to consumers by brokers by adding such disclosures as the types of services that the broker will perform, the amount of the brokers total compensation for performing those services (including yield spread premiums), and whether or not the broker has an agency or fiduciary relationship with the borrower. Additionally, the 2001 policy statement clarifies that borrowers should be made aware of the trade-off between upfront costs and rates, and that such information should be provided to the applicant early in the loan transaction.

The Secretary has announced that he will push forth with rulemaking in this area. MBA agrees with the Secretary's initiatives and will strive to work with HUD to achieve the best possible regulatory outcome to rid the market of abusive lending practices. We think it is important to point out, that current Federal rules and regulations already provide for a great deal of consumer disclosures. We note, for example, that yield spread premium payments are today included as part of the finance charge calculations, and thus, are fully disclosed to consumers through the APR disclosure under the Truth in Lending Act. We note also that these yield spread premium payments must be specifically broken out and separately itemized and disclosed on the Good Faith Estimate and HUD–1 forms under RESPA. That statute also requires that lenders and/or mortgage brokers deliver to consumers a Special Information Booklet that sets forth an explanation of mortgage broker compensation, points, fees, and their interrelationship.

As an industry, we welcome additional disclosure requirements if they truly serve to protect consumers from unscrupulous practices. We note, for instance, that MBA took a leadership role in creating model, voluntary and supplemental disclosures for its members to use. These disclosures provide further explanations of the choices borrowers have to compensate their mortgage brokers—through direct payments, yield spread premiums financed through higher interest rates, or some combination

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[9] For instance, HUD's official position on the test for liability of yield spread premiums before the issuance of the 1999–1 Statement of Policy confirms that this principle is longstanding policy at HUD. Specifically, HUD's General Counsel from the Clinton Administration, Gail Laster, gave testimony at a Joint Hearing on RESPA Reform, convened on July 22, and September 16, 1998, before the House Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Housing and Community Opportunity. In relevant part, Ms. Laster testified as follows:

Ms. VELAZQUEZ. Thank you very much, Madam Chairwoman. . . . Could you answer one simple question for me? Are yield spread premiums legal or illegal?

Ms. LASTER. It depends on whether or not the fee is reasonably related to the goods or services provided. That is not a legalism, but I think in terms of understanding the RESPA statute, it is not a ratemaking statute. We cannot promulgate a rate that says this is legal. By statute, Congress has prescribed that we examine on a case-by-case basis whether or not a fee is reasonably related to the services provided. (emphasis added).

of the two. This additional disclosure was commended and encouraged by HUD,[10] and is now an accepted and routine part of the disclosure process for our membership.

MBA believes, however, that ultimately, we can do much better. We can, and should, construct systems of consumer protection that go beyond mere disclosures. In the end, consumers run the risk of being tricked and deceived as long as consumers are subjected to the arcane and outdated disclosure system that is now mandated by Federal law. As with predatory lending, we believe that it is absolutely essential to enact comprehensive reform of the current mortgage lending laws. So long as the mortgage process remains confusing and perplexing, consumers will run the risk of being gouged and defrauded, whether through trickery involving yield spread premiums, or through other schemes that unscrupulous actors will continue to develop to exploit the unwary and unsophisticated. We look forward to working with HUD and the Congress to enact the necessary legislative and regulatory changes necessary to achieve the goals of lasting protections for all consumers.

Conclusion

To summarize, Mr. Chairman, we reiterate that as we develop more protections and disclosures in this area, we must keep in mind that yield spread premiums are extremely valuable consumer financing mechanisms, and that they are a crucial element in today's housing and mortgage markets. As lenders, Government, and consumer advocates, we all share in the responsibility of ensuring that this important financing tool is not abused by unscrupulous actors or damaged by frivolous class action claims. Going forward, we fully support HUD's calls for improved consumer disclosures and we look forward to working with the Department as we advance on this very important endeavor.

Thank you for the opportunity to share our views with the Committee.

PREPARED STATEMENT OF JOSEPH L. FALK

PRESIDENT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

JANUARY 8, 2002

Mr. Chairman and Members of the Committee, I am President of the National Association of Mortgage Brokers (NAMB), the Nation's largest organization exclusively representing the interests of the mortgage brokerage industry. We appreciate the opportunity to address the Committee today on behalf of the Nation's mortgage brokers on the subject of yield spread premiums.

NAMB currently has more than 13,000 members and 41 affiliated State associations nationwide. NAMB provides education, certification, industry representation, and publications for the mortgage broker industry. NAMB members subscribe to a strict code of ethics and a set of best business practices that promote integrity, confidentiality, and above all, the highest levels of professional service to the consumer.

The Committee has asked for NAMB's views on the recent Statement of Policy 2001–1 issued by the Department of Housing and Urban Development concerning yield spread premiums, and our views concerning what HUD should do going forward to prevent the "abusive use" of yield spread premiums. Before discussing these two issues in detail, we would first like to review the important role mortgage brokers play in our mortgage market and our Nation's economy, and why yield spread premiums are so important to the effective functioning of the market. We will then discuss why NAMB believes the Statement of Policy issued by HUD was both necessary and correct, and offer NAMB's views regarding HUD's actions going forward.

The Importance of Mortgage Brokers in Today's Economy

Today, our Nation enjoys an all-time record rate of homeownership. While many factors have contributed to this record of success, one of the principal factors has been the rise of wholesale lending through mortgage brokers. Mortgage brokers have brought consumers more choices and diversity in loan programs and products than they can obtain from a branch office of even the largest national retail lender. Brokers also offer consumers superior expertise and assistance in getting through the tedious and complicated loan process, often finding loans for borrowers that may have been turned down by other lenders. Meanwhile, mortgage brokers offer lenders a far less expensive alternative for nationwide product distribution without huge investments in "brick and mortar."

[10] 66 Fed. Reg. at 10087.

In light of these realities, it is no surprise that consumers have increasingly turned to mortgage brokers. Today, mortgage brokers originate approximately 65 percent of all residential mortgages in America. In Florida alone, there are over 23,000 licensed mortgage brokers. The rise of the mortgage broker has also significantly increased competition in the mortgage industry, resulting in a decline in mortgage interest rates and closing costs and an explosion in the number of mortgage products available to consumers. These positive developments are not mere coincidences. They would not have been possible without the advent of wholesale lending through mortgage brokers.

Mortgage brokers play an extremely important role in our economy. Following the collapse of the savings and loan industry in the 1980's, and then the rapid consolidation of mortgage banking firms in the 1990's, we now find that in many communities, particularly in central cities and small towns, people may have a difficult time finding a retail bank branch or retail mortgage lending branch. If they do find a retail lender, their mortgage choices are limited to the products and services offered by that lender, which often are very few. But almost any consumer can find a mortgage broker right in their community that can provide access to many loan programs, assist in clearing up credit problems, help clear title defects, and provide other assistance to help the consumer obtain a loan that suits his or her financial needs and objectives.

Mortgage brokers are generally small business owners. The average mortgage broker employs fewer than 10 people. Mortgage brokers know their neighbors, build their businesses primarily through referrals from satisfied customers, and succeed by becoming active members of their communities. The fact that small mortgage brokerages originate over half of all mortgages, indicates that mortgage brokers are effectively meeting consumers' desires for convenience, service, and competitive prices.

Since the middle of 2000, the Nation's economy has been experiencing a slowdown, with increasing unemployment and business failures, declining consumer spending, and other negative economic indicators. The one bright spot in this cloudy picture has been the housing and mortgage finance sector. Mortgage originations increased in 2000 from 1999, and again in 2001. Many mortgage lenders and mortgage brokers experienced record volumes of business in 2001. Mortgage lending has been a vital counterweight as the rest of the economy entered a recession.

Even in today's weakened and uncertain economy, home sales and new home construction continue to increase. This creates and sustains hundreds of thousands of jobs in real estate, construction, and ancillary industries. Mortgage refinances have benefited many homeowners, allowing them to reduce their monthly payments, convert to shorter term loans to save thousands of dollars in total interest, or access their home equity to improve their financial situation. Today, total home equity held by American households once again exceeds the total value of other investments. When properly used, access to home equity has become a lifeline for many seniors whose retirement funds have been dramatically reduced by the decline in the stock market, and for families who face layoffs or uncertain employment prospects in the next several months.

Mortgage brokers provide the flexibility and capacity for the market to absorb a huge volume of new originations, as has occurred in the last few months. This capacity allows consumers to immediately take advantage of interest rate declines and to access their home equity if needed. If mortgage brokers did not exist, lenders with brick-and-mortar offices would not have been able to handle the surge of purchase and refinance business that has been so helpful to consumers and to our economy in the last year.

It is thus vitally important to America's homeowners and to the economy as a whole that we avoid any new regulations, legislation, or legal decisions that could impede the efficient and effective functioning of the wholesale mortgage market.

Yield Spread Premiums and Their Importance

One of the barriers to homeownership is insufficient cash for a downpayment or to pay closing costs. Mortgage brokers have originated hundreds of thousands of loans for people who were able to buy a home, refinance an existing mortgage at a lower interest rate, or obtain a home equity loan with little or no cash required for upfront closing costs or broker fees. These costs are financed through a slightly higher interest rate than the borrower would pay if he or she paid the closing costs in cash. Most retail lenders (for example commercial banks, thrifts, credit unions, and retail mortgage companies) also offer "no- or low-cost" loans at slightly higher rates.

The ability of consumers to obtain loans with little or no upfront costs is critical in today's economy. In uncertain times such as these, people want to conserve and to build up their cash reserves and reduce monthly payments. Interest rates have fallen in the last year to the extent that homeowners can still often reduce the rate on their existing mortgage through a refinance and save thousands of dollars in interest payments, lower the payments, and conserve cash, by paying some or all closing costs through a higher interest rate. When a mortgage broker arranges such a loan, the broker receives most or all of its compensation indirectly from the lender—a yield spread premium.

Such indirect compensation paid by lenders to mortgage brokers is legal under the applicable Federal law, the Real Estate Settlement Procedures Act or RESPA, so long as the total compensation to the broker is reasonably related to services actually performed, goods actually provided, or facilities actually furnished. In all loans originated by mortgage brokers, the broker is providing a facility to the wholesale lender, in effect serving as the lender's branch office. The broker also does most, if not all of the work in assembling the loan package, which is creating a good, and which can often require a great deal of time and expense. Brokers typically take the application, order the appraisal and credit report, verify the borrower's income and employment, and perform many other aspects of loan origination that benefit the lender and enable it to underwrite and approve the loan.

Mortgage brokers also perform services directly for borrowers that are legally compensable. These may include advising the borrower about various loan programs and options to assist the borrower in selecting a loan program that meets his or her financial situation and objectives; helping the borrower improve his or her credit rating in order to qualify for a lower interest rate or better loan terms, and other assistance. Many brokers work late into the evenings and on weekends taking applications, gathering documents, and meeting borrowers at their homes and offices. Such personal and convenient service is one reason mortgage brokers are preferred by many consumers.

Mortgage brokers clearly provide legally compensable services, goods, and facilities to both wholesale lenders and to borrowers. These services, goods, and facilities all ultimately benefit the borrower, by enabling the borrower to qualify for and receive the loan the borrower wants. Retail lenders perform similar origination functions and earn similar fees when they sell mortgages into the secondary market, as they do with the vast majority of loans they originate. However, retail lenders do not disclose to borrowers their income on loans that are subsequently sold in the secondary market. Mortgage brokers do.

We want to emphasize this. There is nothing fundamentally different about the way retail lenders and mortgage brokers earn income. The only difference is that consumers know how much the originator is being paid *only* when the originator is a mortgage broker. This is because HUD requires the disclosure and itemization of all such "indirect compensation" by lenders to mortgage brokers, on both the Good Faith Estimate and the HUD–1 settlement statement. Loan sales by retail lenders are considered secondary market transactions, which are not subject to RESPA.

Mortgage interest rates are highly competitive. Consumers today are more sophisticated than ever in researching and shopping rates. A mortgage broker determines the fee on a particular loan based on a number of factors, including the work required to arrange the loan, such as assisting the borrower in improving his or her credit rating. Fees may also be determined based on the loan program, market competition, and many other factors. The flexibility of indirect compensation allows mortgage brokers to stay competitive with, and often beat, retail lenders on price while still earning a reasonable profit.

It is also important to note that in most cases involving payments of yield spread premiums, the mortgage broker receives nothing until the loan closes. Mortgage brokers often do a great deal of work to arrange loans that never get to closing, for a variety of reasons. They receive no compensation for this work.

HUD Statements of Policy 1999–1 and 2001–1

Despite the clear advantages of mortgages involving yield spread premiums, the clear legality of such payments, and the clear choices being made every day by consumers to obtain their mortgages through mortgage brokers, the wholesale mortgage market is under assault in the courts. Trial lawyers across America have continued to file and pursue class action lawsuits claiming that *all* yield spread premiums are illegal under Section 8 of RESPA. Over 150 such class action lawsuits are active in courts across the country against virtually every major wholesale mortgage lender. Some of these suits were first filed in 1996.

Many courts have dismissed such suits, rightfully in our view. Others have been withdrawn after courts refused class certification. However, some courts have allowed these suits to continue, and trial lawyers continue to venue-shop and file new suits, in search of one court that will agree with their inaccurate portrayal of the wholesale mortgage market. This flood of litigation, and differing opinions of various courts, has caused a great deal of uncertainty and anxiety in the mortgage industry. The cost of defending these class actions is staggering, already running into millions of dollars each for the largest lenders involved. These costs are, of course, passed on to consumers. The potential liability for the industry is tens of billions of dollars. Lenders could be forced to cease all wholesale lending if a judgment goes against even one lender, or if a major settlement occurs.

The only real winners here are the class action attorneys who stand to win millions of dollars in contingency fees. Their clients stand to receive only small refunds, or a few dollars off the cost of their next loan. The real impact will be the exit from wholesale lending of most, if not all, major mortgage lenders. The potential liability for them will simply be too great to justify staying in the business. The real losers will then be tomorrow's first-time homebuyers, tomorrow's working families, and tomorrow's entrepreneurs who will not be able to get a mortgage without paying hundreds of dollars upfront—which, for low-income people without cash, will mean no mortgages at all.

Many small businessmen and women may not be able to stay in business as mortgage brokers without being able to offer consumers low- or no-cost loans. As competition decreases, all potential mortgage borrowers will experience higher costs and fewer choices—and in some cases, no choices at all. The ripple effect on the overall economy, as mortgage borrowing declines and employment in the housing and mortgage finance sector falls, could be substantial.

In 1998, Congress made its views clear on this issue. In the Conference Report accompanying the VA–HUD and Independent Agencies Appropriations Act of 1999 [H.R. Conf. Rep. No. 105–769, 105th Congress, 2d sess. 260] Congress explicitly stated that it was "concerned about the legal uncertainty [regarding indirect compensation] that continues absent such a policy statement." Congress further stated that it "never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of Sections 8(a) or (b) of the Real Estate Settlement Procedures Act (12 U.S.C. 2601 *et. seq.*) Congress directed the Department of Housing and Urban Development (HUD) to issue a statement of policy clarifying the legality of mortgage broker compensation paid by lenders. Congress further directed HUD to consult with all interested parties in developing this policy statement.

HUD followed the directive of Congress with the release of Statement of Policy 1999–1 [FR Vol. 64, No. 39, pp. 10080–10087] on March 1, 1999. The policy statement says that:

> In determining whether a payment from a lender to a mortgage broker is permissible under Section 8 of RESPA, the first question is whether goods or facilities were actually furnished or services were actually performed for the compensation paid. The fact that goods or facilities have been actually furnished or that services have been actually performed by the mortgage broker does not by itself make the payment legal. The second question is whether the payments are reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed.

NAMB participated in the development of this Statement of Policy, along with many other industry groups, as well as major consumer advocacy organizations. HUD, to its credit, insisted that a consensus of all the participating groups be reached. All who participated agreed that Statement of Policy 1999–1 correctly interpreted RESPA as it relates to mortgage broker compensation. The policy statement enjoyed bipartisan approval from the Clinton Administration and Congress.

When Statement of Policy 1999–1 was released, most of us in the mortgage industry believed the litigation crisis had been resolved. Using the "two-part test" set forth in the statement meant that the legality of any mortgage broker compensation would have to be judged on a case-by-case basis, not as a class action. It is important to note here that this test allows individual cases of abuse to be addressed and remedied in court, while limiting inappropriate class actions. Following the publication of the statement, the number of new class action lawsuits dwindled. Several existing lawsuits were dismissed, and class certification was denied, by courts that agreed with HUD's interpretation of RESPA and agreed that broker compensation must be judged on a case-by-case basis. However, other lawsuits continued to proceed with the hope by the trial lawyers that a court might interpret Statement of Policy 1999–1 in such a way that a class action could still go forward.

Unfortunately, this occurred in June 2001, when the Eleventh Circuit Court of Appeals affirmed certification of a class by the U.S. District Court of Alabama in *Culpepper* v. *Irwin Mortgage Corp.* The Eleventh Circuit found an ambiguity in

Statement of Policy 1999–1, and failed to complete its analysis of yield spread premiums by only applying the first test. The Court also implied that a lower court could, in fact, find that all yield spread premiums are illegal, thereby justifying certification of the class. Not surprisingly, NAMB believes this was a misinterpretation of both RESPA and Statement of Policy 1999–1. It left the industry once again facing billions of dollars in liability. It also left HUD in contravention of the 1998 Congressional directive to provide definitive guidance to the industry and clarify any legal ambiguities surrounding mortgage broker compensation. Dozens of new lawsuits have been filed since the Eleventh Circuit decision. Clearly this is not because of a sudden rampant wave of abuse in the mortgage market, but because class action attorneys see an opportunity for multimillion dollar fees.

HUD immediately recognized the potential disaster created by this decision, and recognized its responsibility to remove the ambiguity found by the Eleventh Circuit by clarifying its existing policy. In the process of developing its response, HUD once again met with a wide range of interested parties, including NAMB, and including consumer advocacy groups. On October 15, 2001, HUD issued Statement of Policy 2001–1 [Fed. Reg. 66, No. 202, pp. 53052–53059]. HUD states in the preamble to this policy statement that:

> This Statement of Policy is being issued to eliminate any ambiguity concerning the Department's position with respect to those lender payments to mortgage brokers characterized as yield spread premiums. . . . In issuing this Statement of Policy, the Department clarifies its interpretation of Section 8 of the Real Estate Settlement Procedures Act (RESPA) in Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers (the 1999 Statement of Policy). . . . Today's Statement of Policy reiterates the Department's position that yield spread premiums are not *per se* legal or illegal, and clarifies the test for the legality of such payments set forth in HUD's 1999 Statement of Policy. As stated there, HUD's position that lender payments to mortgage brokers are not illegal *per se* does not imply, however, that yield spread premiums are legal in individual cases or classes of transactions. The legality of yield spread premiums turns on the application of HUD's test in the 1999 Statement of Policy as clarified today.

HUD is to be congratulated for Statement of Policy 2001–1. The statement is simply a clarification of existing policy and the existing views of HUD concerning yield spread premiums. As the regulator of RESPA, HUD has a responsibility to provide all parties affected by RESPA with clear rules and guidance so that the law can be effectively understood and implemented nationwide, and so that nationwide lenders can comply with the law. Continued ambiguity, whether created by court decisions, market changes, or other factors, creates unnecessary and costly uncertainty for both business and consumers. The only parties that benefit from ambiguity are trial lawyers.

Statement of Policy 2001–1 has also been accepted by the courts in two important court rulings in class action lawsuits, *Vargas* v. *Universal Mortgage Corp.* and *Bjustrom* v. *Trust One Mortgage Corp.* In *Bjustrom,* U.S. District Judge Marsha J. Pechman of the Western District Court of Washington granted summary judgment to the defendant, Trust One Mortgage Corp. Judge Pechman applied the new policy statement to find that yield spread premiums are not illegal *per se* even though there may be no "tie" between the premium and particular services performed by the broker. The Court found that the Statement of Policy is a permissible interpretation of RESPA and therefore must be given deference.

In *Vargas,* Judge James B. Zagel of the U.S. District Court, Northern District of Illinois, denied certification of a class. Judge Zagel agreed with HUD that the fact that yield spread premiums are calculated based on a rate sheet does not make them *per se* illegal referral fees. He also found that there are legitimate reasons why a borrower would choose to pay a higher interest rate on a loan that included a yield spread premium. Importantly, Judge Zagel also found that HUD's two-part test to determine legality of a yield spread premium is faithful to the RESPA statute, and that:

> . . . the Act [RESPA] compels a case-by-case analysis of individual plaintiffs' claims every bit as much as the HUD Statement. HUD's "reasonableness requirement" was not made out of whole cloth; it is implicit in § 2607(c) which authorizes compensation for "services actually performed."

We expect other courts to agree with these two decisions. Yield spread premiums that are properly disclosed and meet the HUD test should be considered legal and not abusive. Any yield spread premium that does not meet this test may be illegal, and HUD's policy statement clearly allows consumers who believe their loan has included an illegal yield spread premium to seek legal remedy. With the legal uncertainty removed, our industry can now move forward and HUD can move forward to address the real problems in the mortgage market.

HUD's Actions Going Forward

The other issue on which the Committee has asked us to comment is what HUD should do going forward to address "abusive use" of yield spread premiums. We fully agree that illegal uses of yield spread premiums should be prosecuted to the full extent of the law. Any compensation that does not meet the HUD test is illegal, and those paying or receiving illegal payments should be punished. The NAMB believes such abuses are rare, and we believe that HUD is moving forward appropriately in two ways.

First, HUD is moving to more aggressively enforce RESPA and punish violators. It is devoting more resources, reorganizing, and refocusing to dramatically improve its historically poor record in enforcing RESPA. Our industry has long been frustrated with the lack of RESPA enforcement by HUD. Even a little enforcement can go a long way in serving notice to all settlement service providers that there will be a high price for violating the law. This includes the payment or receipt of illegal yield spread premiums or any other fees that are paid to any industry participant in violation of RESPA. NAMB applauds HUD's new enforcement effort and hopes Congress will support it with increased funding and personnel allocations.

The other way HUD is moving to address abuses is with a new RESPA regulation. In Statement of Policy 2001–1, HUD announced:

> This Statement of Policy also reiterates the importance of disclosure so that borrowers can choose the best loan for themselves, and it describes disclosures HUD considers best practices. The Secretary is also announcing that he intends to make full use of his regulatory authority to establish clear requirements for disclosure of mortgage broker fees and to improve the settlement process for lenders, mortgage brokers, and consumers.

Secretary Martinez, in remarks before this Committee on December 13, 2001, further stated his commitment to RESPA reform:

> To ensure that homebuyers have the information they need in order to make an informed purchase, I have undertaken comprehensive reform of the Real Estate Settlement Procedures Act (RESPA). In addition to preserving yield spread premiums as a valuable tool for opening the doors of homeownership, reform will: (1) ensure better protections for new homebuyers and those who refinance; (2) offer clarity for the mortgage lending industry about their disclosure responsibilities, and; (3) provide an additional tool to fight predatory lending.
>
> The need for RESPA reform is even more urgent during times of economic uncertainty. Homeownership helps create financial stability for families, and in return brings economic stability to our communities.

NAMB fully agrees with Secretary Martinez and we support a new rulemaking to improve the disclosures provided to consumers. Mortgage brokers are confronted every day with the frustrations of our customers about the many confusing, and largely useless, disclosures and paperwork we thrust at them. Consumers who may be desperate for cash or credit may not always fully investigate their loan options or closely examine the many disclosures they receive.

Consumers are entitled to better, simpler disclosures provided earlier in the process, so they can more effectively compare loans. Consumers should have simple disclosures without a lot of fine print. They should easily be able to question and change terms and fees with which they do not agree, well before closing. These improvements could reduce compliance burdens and costs for originators, and the savings would be passed on to consumers. Consumers would be in a stronger position with more information, thereby decreasing the incidence of abusive lending practices of all kinds—including, but not limited to, any illegal yield spread premiums.

NAMB has developed detailed proposals for this rulemaking, and we have shared these with HUD and with this Committee. NAMB supports a new, mandatory disclosure to be required of all originators at or before application, that clearly defines what the originator will do in the transaction, how its compensation will be earned, and the choices available that could affect both the way the originator is compensated and whether the consumer will have to pay any fees upfront at closing. NAMB also supports establishing tolerances for the Good Faith Estimate and requiring redisclosure if the tolerances are exceeded, in order to prevent surprise additional costs to consumers at closing, including inappropriate increases in yield spread premiums.

This new disclosure would build upon the successful Model Loan Origination Agreement that NAMB and MBA jointly developed in 1998, and which both associations encourage our members to use. We believe this new agreement will help consumers better understand the process, while not adding significantly to the complexity of that process.

Conclusion

Wholesale mortgage lending through mortgage brokers, and particularly the wide availability of loans requiring the borrower to pay little or no cash at closing, is a key element in sustaining America's economy through this period of great uncertainty and difficulty. Used properly, yield spread premiums are an important part of this market, and it is therefore important to consumers that the use of legal yield spread premiums continue, without the threat of class action litigation that could seriously impede the efficient functioning of the market and damage the economy. When yield spread premiums are properly disclosed and properly used, they are not illegal.

NAMB believes that HUD has acted responsibly as the regulator under RESPA: First, by issuing Statement of Policy 2001–1 to clarify existing policy concerning yield spread premiums, provide certainty to the mortgage industry, and reduce the threat of class action litigation; second, by significantly increasing and improving its investigation and enforcement of RESPA violations; and third, by developing new and improved disclosures that will help consumers avoid illegal and abusive fees. NAMB supports a new, mandatory disclosure to be provided at the earliest possible time by all originators that fully informs consumers about the loan origination process. NAMB also supports improving the Good Faith Estimate by establishing tolerances and requiring redisclosure.

Thank you again for this opportunity to share NAMB's views with the Committee.

PREPARED STATEMENT OF IRA RHEINGOLD

EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

JANUARY 8, 2002

Mr. Chairman and Members of the Committee, the National Association of Consumer Advocates[1] thanks you for inviting us to testify today regarding HUD's recent policy "clarification" on yield spread premiums. We offer our testimony here today on behalf of our members, as well as the National Consumer Law Center.[2]

At the outset, let me make it perfectly clear that while we believe that the use of yield spread premiums can be a source of benefit for American consumers, this practice as it is currently being used by the mortgage lending industry, is both abusive and deceptive. Furthermore, instead of carrying out its mandate to promote homeownership by encouraging a fair, open, and honest marketplace, HUD has attempted to use its policymaking authority to legitimatize the otherwise illegal, anti-competitive nature of yield spread premium abuse. This testimony will discuss how yield spread premiums currently operate in the real world, explore previous efforts to regulate this practice, explain how HUD's purported clarification in the 2001 policy statement ignores the law and perpetuates and encourages bad lending behavior and finally, offer proposals to make the use of yield spread premiums provide American homeowners with real benefit.

Yield Spread Premiums in the Current Marketplace

Section 8(a) of RESPA prohibits any person from giving or receiving any fee, kickback or thing of value pursuant to any agreement incident to a real estate settle-

[1] The National Association of Consumer Advocates is a nonprofit organization designed to promote justice for all consumers by maintaining a forum for information sharing among consumer advocates across the country. Our mission is to serve as a voice for consumers in the ongoing struggle to curb unfair and abusive business practices, especially in the areas of finance and credit.

[2] The National Consumer Law Center, Inc. (NCLC) is a nonprofit Massachusetts corporation founded in 1969 at Boston College School of Law and dedicated to the interests of low-income consumers. NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, Government and private attorneys across the country. *Cost of Credit* (NCLC 1995), *Truth in Lending* (NCLC 1996) and *Unfair and Deceptive Acts and Practices* (NCLC 1991), three of twelve practice treatises published and annually supplemented by NCLC, and our newsletter, *NCLC Reports Consumer Credit & Usury Ed.,* describe the law currently applicable to all types of consumer loan transactions.

ment involving a Federally related mortgage.[3] This rather simple provision was the product of much debate in Congress and was created in 1972 because of the widespread recognition that referral fees and kickbacks were making the marketplace anticompetitive (homebuyers were not being directed to a service provider who would provide them with the best deal, but instead to the provider who would pay the largest sum of money to the referring agent).[4] The rationale for this legislation was simple. Eliminate market-distorting incentives and homeowners would have real opportunity to obtain the most beneficial and cost efficient loan products available. While Section 8(a) of RESPA seems rational, fair, and explicit, current participants in the home lending marketplace have gone to great effort to obfuscate the law and preserve their ability to receive and provide kickbacks at the great expense of American homeowners. This is where the practice of yield-spread premiums (YSP's) enters our story.

In a nutshell, the YSP's are payments made by a lender to a mortgage broker in return for a referral of an "above-par" loan. An above-par loan is a loan with a YSP paid to the broker and a higher interest rate than the loan the borrower qualified for. A par loan is a loan with an interest rate that an individual homeowner would qualify for if she/he paid no discount points and was charged no YSP. For a "below-par" loan, the homeowner would pay discount points in exchange for the lower interest rate.

In theory YSP's could offer homeowners using a mortgage broker a valuable choice. Borrowers could choose the amount of points they would want to pay (or not pay) and thus choose an interest rate. For instance, a homeowner who did not want to pay an upfront broker fee, could choose an above-par interest rate and have the lender pay the broker in the form of a YSP. While this could all be so very neat and clean *(and legal),* this scenario does not remotely reflect what is happening in today's consumer marketplace.

Consumers who do business with mortgage brokers generally have the understanding that the brokers will provide them the loan at the lowest rate that the broker finds for them. Consumers have generally understood and agreed to a specific broker's fee to be paid directly by them—either in cash or by borrowing more—to the mortgage broker to compensate the broker for obtaining the loan. What consumers do *not* understand, and have not agreed to, is the mortgage broker receiving an *additional* fee from the lender.

As an attorney for the last 5 years running a foreclosure prevention project in Chicago, I have had the opportunity to review hundreds and hundreds of loan documents. I have probably interviewed thousands of homeowners, given countless seminars and trained and spoke with scores of attorneys representing consumers. In all that time, I have seen countless loans that contained both yield spread premiums and borrower paid broker fees, yet *not once,* have I spoken to a homeowner who knew that a YSP had been paid on their loan, or that because of the YSP, the interest rate they received was greater than they were otherwise qualified. To some, this evidence is anecdotal, but both industry commentary[5] and objective study[6] bear this observation out. This reality begs two questions. First, if YSP's are not being paid for the benefit of consumers, why are they being paid? Second, if these are referral fees why aren't these payments illegal?

The answer to the first question is very simple. YSP's are generally paid by the lender to the broker *solely in compensation for the higher rate loan.* In other words, because the broker brings to the lender a loan at a higher rate than the consumer would otherwise qualify, the broker is paid a fee, or kickback. These fees are solely an extra fee that the broker is able to extract from the deal. In practice, the borrower is not only paying an upfront broker fee, but is also paying a higher interest rate as a result of this kickback. As this practice clearly provides an incentive for brokers to obtain above-par loans for consumers, the dynamics of the marketplace

[3] Reg. X § 3500.14(b).

[4] For a detailed discussion of RESPA's legislative history see the Report of Howell Jackson in *Glover* v. *Standard Federal Bank,* pp. 3–19.

[5] Professor Jack Guttentag, Professor of Finance Emeritus at the Wharton School (whose nationally syndicated "Ask the Mortgage Professor" columns are featured on the Mortgage Bankers Association of America's own website) recently conducted a study of mortgage broker fees. That study, Bankers Association of America's own website) recently conducted a study of mortgage broker fees. That report, entitled "Another View of Predatory Lending" (published by the Wharton Financial Institutions Center and available as a free download from its website), found that there is no correlation between the fees paid to a mortgage broker on a given loan and the amount of work performed by the mortgage brokers on that loan. The Guttentag Study concluded that the only two "major determinants" of mortgage broker profit are "loan size" and "the sophistication of the borrower relative to the sales skills of the loan officer.

[6] Report of Howell Jackson.

closely resemble the marketplace that Congress attempted to control with its passage of RESPA.

Prior Attempts To Curb Yield Spread Premium Abuse

Because this problem has existed for over a decade (and because the lending industry has attempted various justifications for this seemingly obvious illegal practice), there has been extensive litigation. The industry had sought assistance from Congress in the past. Finally, in 1998, Congress issued a directive to HUD to write a Statement of Policy. Consumer representatives worked diligently with the mortgage industry and HUD to develop the language.[7] The Statement of Policy that was issued by HUD in 1999 met with both consumer advocate and industry approval. Consumer advocates approved of the policy statement in large part because of the explicit direction provided to the lending industry on how a lender can properly pay a broker fee:

> Mortgage brokers and lenders can improve their ability to demonstrate the reasonableness of their fees if the broker discloses the nature of the broker's services and the various methods of compensation at the time the consumer first discusses the possibility of a loan with the broker.
>
> [T]he most effective approach to disclosure would allow a prospective borrower to properly evaluate the nature of the services and all costs for a broker transaction, and *to agree* to such services and costs before applying for a loan. Under such an approach, the broker would make the borrower aware of . . . the total compensation to be paid to the mortgage broker, including the amounts of each of the fees making up that compensation. *If indirect fees are paid, the consumer would be made aware of the amount of these fees and their relationship to direct fees and an increased interest rate.* If the consumer may reduce the interest rate through increased fees or points, this option also would be explained. [Emphasis added.][8]

With this clear direction on how to avoid liability for paying broker fees, consumer advocates reasonably believed that the mortgage industry would immediately adopt these recommendations and employ them in all future loans. This belief was wrong. Instead the industry continued as before—lenders continued to pay broker fees without evaluating either the services provided by the broker or whether the payment of the lender fee reduced the fees otherwise owed by the borrower. Because the benefit to the brokers and lenders was so great (higher fees for brokers, higher interest rates for lenders), the mortgage industry's strategy was to continue its illegal practice, pay off the few individual actions brought against it and mount a massive effort to fight class action cases challenging the payment of these fees, which might actually cost the industry real money and cause the industry to change its behavior.

Initially after the 1999 Statement of Policy this strategy appeared to be working. Most Federal courts generally denied class certification, requiring an intensely factual analysis to determine legality,[9] while a few Federal district courts did permit the class actions to proceed. [10] This scene changed significantly however, when the Eleventh Circuit Court of Appeals issued a comprehensive analysis of RESPA's requirements regarding referral fees, the 1999 Statement of Policy, and upheld class certification, on June 15, 2001.[11]

The crux of the analysis in the *Culpepper* case is that for HUD's Statement of Policy to be consistent with RESPA, a two-part test is necessary to determine the legality of the lender paid broker fees. First, whether the lender paid fee was *for* goods, services, or facilities provided. Second, whether the total fee paid was reasonable.[12] The court found class certification appropriate because—

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[7] "The conferees expect HUD to work with representatives of industry, Federal agencies, consumer groups, and other interested parties on this policy statement." See the Conference Report on the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1999, H.R. Conf. Rep. No. 1050769 at 260 (1998).

[8] Real Estate Settlement Procedures Act Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers. 64 FR 10080 (March 1, 1999) at 10087.

[9] See for example *Golan* v. *Ohio Savings Bank,* 1999 U.S. Dist. LEXIS 16452 (N.D. Ill. October 15, 1999); *Brancheau* v. *Residential Mortgage,* 187 F.R.D. 591 (D. Minn. 1999); *Levine North Am. Mortgage,* 188 F.R.D. 320 (D. Minn. 1999); *Smitz* v. *Aegis Mortgage Corporation,* 48 F. Supp. 2d 877 (D. Minn. 1999).

[10] *Heimmermann* v. *First Union Mortgage,* 188 F.R.D. 403 (N.D. Ala. 1999); *Briggs* v. *Countrywide Funding Corporation,* 188 F.R.D. 645 (M.D. Ala. 1999).

[11] *Culpepper* v. *Irwin Mortgage Corporation,* 253 F. 3d 1324 (11th Cir. 2001).

[12] A significant basis for this rationale is not only HUD's 1999 Statement of Policy, but also the language of RESPA's provision distinguishing between legal fees and referral fees. Section 8(c) of RESPA permits "the payment of a fee . . . by a lender . . . *for services actually performed.*" 12 U.S.C. § 2607(c)(1)(C). 253 F.3d at 1328. (Emphasis added.)

> The terms and conditions under which a lender pays the broker a yield spread premium can determine whether the yield spread premium is compensation for referring loans rather than a *bona fide* fee for services. There is no suggestion from the evidence or the argument here that Irwin negotiates yield spread premiums loan-by-loan, rather than paying them according to terms and conditions common to all the loans.[13]

In essence, the Culpepper court was saying, if the lender paid a broker a yield spread premium without looking at whether services were provided, the lenders practice violated RESPA. Therefore, the first step of the two-part test—whether the lender paid fee was *for* services—could be answered without performing a factual analysis of each individual loan. Therefore, the court concluded that there was no reason that the case could not proceed as a class action. The court noted that the formula by which a lender paid broker fee is paid "does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker services."[14]

The mortgage industry responded to the *Culpepper* case by immediately turning to HUD and seeking a "clarification" of the 1999 Statement of Policy removing all references to language, which would support the Eleventh Circuit Court's analysis. The stated rationale was simply to "clarify" the "ambiguity" in the policy statement.[15] Despite the fact that the 1999 Statement of Policy was unambiguous regarding how the industry could legally pay yield spread broker fees, the industry coyly requested:

> HUD must issue decisive and clear rules that benefit both borrowers and lenders by creating a regulatory environment in which consumers can make informed choices and lenders can operate their businesses, without the constant prospect of having industry practices that benefit consumers challenged in litigation.[16]

The industry portrayed a "clear rule" for the future as an appropriate trade-off for the requested "clarification of the 1999 Statement of Policy."[17] This completely ignored the obvious—that HUD had already provided a clear rule, just as the industry is now requesting, in the 1999 Statement of Policy, which the industry had simply ignored.

HUD's Actions

In the weeks preceding the issuance of the 1999 Statement of Policy, HUD officials met with consumer representatives on dozens of occasions to work through many of the complex issues involved in this problem. Many of these meetings were also attended by representatives of the mortgage industry. In contrast, prior to the 2001 Statement, HUD officials met with consumer representatives three times, despite numerous requests and offers by these representatives to engage in a more substantial dialogue.[18]

The consumer representatives tried to make clear to HUD officials these essential points:

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[13] 253 F. 3d at 1329.

[14] The factual basis for the court's conclusion was stated in this way:

The "yield spread premiums" at issue in this case . . . are payments from [the lender] to its mortgage brokers that the written agreement between them contemplates, but does not define. Each business day, Irwin distributes a rate sheet to its brokers, listing the terms of the loans Irwin is offering that day. The loans' interest rates are set with reference to a "par rate." If the broker originates a loan at a below-par rate, it gets no compensation from Irwin. On the other hand, originating a loan at an above-par rate garners the broker a yield spread premium, whose amount is determined by a formula that includes the amount of the loan and the difference between the loan rate and the par rate. The formula does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker's services. 253 F. 3d at 1325.

[15] See letter from Anne Canfield, Executive Director of the Consumer Mortgage Coalition, to Secretary Mel Martinez, dated September 25, 2001. *http://www.houselaw.net/alerts/092801a.pdf.*

[16] *Id.*

[17] See memorandum from Howard Glaser, Mortgage Bankers Association, entitled "What We Are Asking For."

[18] On July 11, 2001 consumer representatives met with General Counsel Richard Hauser and other HUD representatives. On September 11, 2001 consumer representatives met for a few minutes with Secretary Martinez, FHA Commissioner Weicher, Mr. Hauser, and others. Given the tragic occurrences of the day, this meeting was aborted and resumed on September 19. On October 11, after numerous requests, consumer representatives again met with Mr. Hauser, Commissioner Weicher, and others.

- Providing the "clarification" of the 1999 Statement as sought by the mortgage industry would have the effect of completely eliminating class actions as a form of redress for illegal lender paid broker fees.[19]
- Without class actions as a means to litigate the legality of these fees, the industry has no incentive to change their practices or even to comply with a new regulation—because there are insufficient legal resources in this Nation to represent consumers in individual actions involving claims of only a few thousand dollars.
- The "new" disclosures offered by the industry—and proposed by HUD—provide *fewer* actual protections for consumers than those recommended by HUD in the 1999 policy statement. Unlike the 1999 recommendations which include the consumer's *agreement* to the lender paid broker fee, the 2001 proposal only mentions "disclosure."[20]
- Limiting illegal lender paid broker fees is an essential step in redressing predatory mortgage lending.

The mortgage industry provided specific language to HUD to "clarify" the 1999 policy statement. HUD adopted every recommendation made by the industry. The crux of HUD's "clarification" comes on page 11, with the statement:

> HUD's position is that in order to discern whether a yield spread premium was for goods, facilities, or services under the first part of the HUD test, it is necessary to look at each transaction individually . . .[21]

Such a position, if deferred to by the courts, would almost certainly preclude class action suits, thus removing the only effective legal recourse to challenge and change this practice. In fact, the 2001 Statement of Policy collapses the two-part test articulated in the 1999 Statement into a single analysis; which represents a serious departure from not only the 1999 Statement, but also the Congressional directive in RESPA.[22]

HUD's action is absolutely crippling to consumer rights, as it removes any incentive the industry has to cooperate with any future action that HUD might take to address the egregious practice of upselling mortgage loans. In his press release, Secretary Martinez claims to be pursuing a reform to require full upfront disclosure of all total compensation to be paid to the broker. However, even if HUD initiates a proposed rulemaking to do this (which was not proposed in the October 15 Statement), and even if the regulation goes beyond the meaningless recommendations in the 2001 Statement, it will be a regulation without any effective enforcement mechanism.

Making Yield Spread Premiums Work for Consumers

Several years ago, Congress requested that the two Federal agencies most familiar with the implementation of the laws involved in the mortgage process—HUD and the Federal Reserve Board—evaluate the complex issues of improving and streamlining the mortgage process, while addressing predatory lending. In 1998, these two agencies issued a comprehensive report.[23] This Joint Report, in addition to proposing comprehensive reform to address predatory lending, also proposed two alternatives to address the fact that the current system does not ensure a truly competitive marketplace for mortgage loans.

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[19] This assumes that a court agrees that the 2001 HUD Statement of Policy should be provided deference. There is substantial legal question regarding the extent of reliance that a court may place on an agency's interpretative statement which has not been subject to notice and comment. The Supreme Court has distinguished between the deference due regulations promulgated by formal notice-and-comment rulemaking or formal adjudications and those made informally. See *Christensen* v. *Harris County,* 529 U.S. 576, 120 S. Ct. 1655, 1662, 146 L. Ed. 2d 621 (1999).

[20] Consumer representatives maintain that requiring the consumer to *agree* to the payment of a lender paid broker fee is an essential element in a regulatory structure that would truly protect consumers from illegal yield spread premiums.

[21] Department of Housing and Urban Development, RESPA Statement of Policy 2001–1: Clarification of Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b) at 11.

[22] The new test "requires that total compensation to the mortgage broker be reasonably related to the total set of goods or facilities actually furnished or services performed." *Id.* at 13. Although HUD *says* there is still a two-part test, the two tests appear identical.

[23] Board of Governors of the Federal Reserve System, Department of Housing and Urban Development,
Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, July 1998 (hereinafter "Joint Report"). These two Government agencies listened to the multitude of industry representatives, as well as consumer representatives, and issued a complex and comprehensive report.

One alternative would be a dramatic change in the system governing the disclosures consumers receive both when they apply for the loan and when they close the loan. The other alternative is to beef up the current system and require information to be provided which is meaningful.

Alternative One

In the Joint Report, HUD indicated its commitment to actually improving the system of shopping for mortgages, rather than continue the confusion. The primary mechanism for accomplishing a more open system would be to require mortgage lenders (and brokers) to provide a guaranteed interest *rate* and closing costs before collecting any application fees from consumers.

As the charges for mortgage loans are often based on the borrower's creditworthiness and the value of the collateral, some underwriting would have to be performed by the creditors before the guaranteed rate could be provided. To its credit, HUD agreed with consumer advocates and proposed that "consumers be provided guaranteed information about closing costs, *interest rate,* and points early enough so that they can shop and make informed choices." [24]

On the other hand, the large mortgage lenders have been pushing hard for a change in the law which would mandate a guaranteed closing costs "package," without a guarantee for rates and points. In this way, the lenders could market their loans based on the closing cost package. Consumer advocates have opposed the closing cost package by itself because it would be like marketing tires to car buyers before they purchase the car: A borrower would likely apply for a loan based on the guaranteed closing cost package, without receiving any guarantee of the interest rate or points. Encouraging borrowers to apply for loans based only the closing cost package would end up costing borrowers in at least two ways: (1) if the actual closing costs incurred by the lender for the loan exceeds the anticipated amount, there would be nothing to prevent the lender from increasing the interest rate or the points charged on the loan to make up for the difference; (2) in fact, there is nothing to prevent the lender from increasing the price of the loan to borrowers who have already paid so much money to apply for the loan, that they cannot afford to go elsewhere for their home loan.

Alternative Two

HUD also proposed a change in the rules governing early disclosures. These early disclosures need to be transformed into commitments to deal with the issue of deceptive yield spread premiums.

The mortgage industry has consistently stated that it wants to ensure that yield spread premiums remain legal so that borrowers can benefit from their use—such as by reducing the upfront closing costs required to be paid from cash or equity. We as consumer advocates agree. We think the following principles,[25] if followed, would guarantee that yield spread premiums would be legal and beneficial for consumers.

1. Before any payment is made to the broker, the borrower and the mortgage broker must enter into a binding fee agreement regarding the total compensation, however denominated, to be paid to the broker.
2. The borrower must be offered a choice of how to pay the broker fee, whether in cash, by borrowing more, by increasing the interest rate or points, or having the lender pay the broker fee. This choice is offered after loan approval but before the settlement.
3. The amount the broker is paid is the same whether paid by the borrower or the lender. The amount paid the broker by the lender reduces, by the exact amount, the amount owed by the borrower to the mortgage broker.
4. The total amount paid by borrower and lender must be reasonable and be compensation for goods, services, and facilities actually provided.

These principles accomplish several things. First, the consumer knows upfront how much the mortgage broker will charge. Second, the consumer is given the opportunity to choose how this payment will be paid. Third, and most importantly, the broker compensation remains the same regardless of method of payment. This point is crucial, because it eliminates any anticompetitive incentive the broker has to place the borrower in a loan with an interest rate greater than they otherwise would qualify. In other words, whether the borrower chooses a below-par loan, a par loan or an above-par loan with a yield spread premium, the broker compensation will remain the same. This is not how the system works today and it must be changed.

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[24] *Joint Report* at XVII.
[25] See Appendix A for a full proposal that amends Reg. X and adopts these principles.

In summary, yield spread premiums have been a source of mortgage lending abuse for a number of years. Finally, when the Federal courts began to seriously hold the mortgage lending industry liable, the industry, instead of reforming its ways turned to HUD for salvation. HUD, instead of protecting consumers, cast its lot with mortgage lenders and attempted to protect the anticompetitive marketplace that currently exists, HUD's ultimately cynical policy clarification was not only disappointing but also an abdication of their mandate to protect and promote homeownership. We can only hope that in the future, HUD will rethink its decision and issue regulations that adopt principles that not only claim to protect consumers, but also in practice actually do.

Appendix A

PROPOSED CHANGES TO REGULATION X

1. Add Following Definitions to § 3500.2(b)

Total compensation received by a mortgage broker for bringing together a borrower and a lender to obtain a Federally related mortgage loan for the borrower includes all payments made by the borrower directly to the mortgage broker in cash or in the form of any thing of value, all payments received from the proceeds of the loan, and all payments received from the lender or any other settlement service provider that are directly related to the brokering of the loan.

Par rate means the interest rate offered to a mortgage broker (through lender's price sheets) at which the lender will fund 100 percent of the loan with no premiums or discounts to the mortgage broker.[26]

2. Add the Following Addition to § 3500.14(g)

§ 3500.14(g)(4): The payment of a fee by a lender to a mortgage broker related to the making of a Federally related mortgage loan shall not violate Section 8 of RESPA (12 U.S.C. § 2607) or § 3500.14 if all of the conditions set forth in this subsection are satisfied.[27]

(i) The mortgage broker agrees to represent the borrower, to act as the borrower's agent, and to get the most favorable mortgage loan that meets borrower's stated objectives.[28]

(ii) Prior to the preparation of the mortgage loan application or receipt of any payment, whichever is first, the mortgage broker and the borrower complete and execute a Mortgage Broker Contract, in substantial conformity with the form in Appendix F to this part, that states clearly and conspicuously:[29]

(A) the mortgage broker's total compensation, expressed both as a dollar amount and as a percent of the loan amount requested by the borrower;

(B) the borrower owes any compensation to the mortgage broker only if the borrower enters into a Federally related mortgage loan with a lender to whom the mortgage broker referred the borrower; and

(C) the available methods by which the borrower can choose to pay the mortgage broker the total compensation in the Mortgage Broker Contract.

(iii) Following loan approval, but no later than five (5) business days before settlement, the lender and borrower enter into a Broker Funding Contract, in substantial conformity with the form in Appendix G to this part, that states clearly and conspicuously:

(A) the available methods by which the borrower can pay the mortgage broker the total compensation disclosed in the Mortgage Broker Contract;

(B) the par rate, the proposed interest rate, and the monthly payment (excluding escrow) of any method described in § 3500.14(g)(4)(ii)(A) when the lender offers to pay all or part of the total compensation to the mortgage broker through funds resulting from an interest rate higher than the par rate for a mortgage loan with otherwise equivalent terms and fees;

(C) that the borrower may select one of the methods described in § 3500.14(g)(4)(ii)(A).

[26] Source: HUD Statement of Policy 1999–1, 64 Fed. Reg. 10080, 10081 n.1 (March 1, 1999).

[27] Source: Language mirrors affiliated business arrangement exemption in 24 C.F.R. § 3500.15(b).

[28] Source: HUD Proposed Rule, 62 Fed. Reg. 53912, 53927 (October 16, 1997) (proposed Mortgage Broker Contract, Appendix F). *See also,* Federal Reserve/HUD Joint Statement to Congress on RESPA/TILA Reform (1998).

[29] Source: HUD Proposed Rule, 62 Fed. Reg. at 53925 (proposed § 3500.14(g)(2)(I)(A).

(iv) The total compensation paid to the mortgage broker compensates the broker for goods, services, and facilities and is reasonably related to the value of such good, services, and facilities.

(v) Any fee paid by the lender to the mortgage broker for the Federally related mortgage loan reduces, dollar for dollar, the amount owed to the mortgage broker by the borrower pursuant to the Mortgage Broker Contract described in § 3500.14(g)(4)(ii) and must be paid at or before the settlement.

(vi) The borrower receives a copy of the Mortgage Broker Contract described in § 3500.14(g)(4)(ii), and the Broker Funding Contract described in § 3500.14(g)(4)(iii).

(vii) The mortgage loan, the Mortgage Broker Contract, and Broker Funding Contract do not contain provisions that waive or restrict the borrower's right to enforce the provisions of RESPA and these regulations or other rights related to the mortgage through judicial process.

3. Add Supplementary Information Regarding Applicable Date

These amendments apply to mortgage loans entered into on or after January 1, 2002 [or other date in the future].

4. Add Appendix F, Mortgage Broker Contract

[TO BE DRAFTED]

5. Add Appendix G, Broker Compensation Contract

[TO BE DRAFTED]

PREPARED STATEMENT OF DAVID OLSON

MANAGING DIRECTOR, WHOLESALE ACCESS MORTGAGE
RESEARCH AND CONSULTING, INC.

JANUARY 8, 2002

Qualifications

I am the Managing Director of an economic research firm. I have been studying the mortgage industry for over 30 years. Since 1991 our firm has conducted much of the primary research on mortgage brokers in the United States. Although I am a member of the MBA and NAMB, I do not represent either association at these hearings. I merely represent myself as an independent economist. I have been asked to comment on the recent Statement of Policy 2001–1 by HUD concerning yield spread premiums (YSP's), and what HUD should do to prevent their abusive use. I also have some thoughts to share about markets, economics, and predatory lending.

In the early days of my professional career, I was a student of socialist systems and spent time in Russia and Eastern Europe. I saw first-hand how miserably socialism operated. It led to slow growth, few benefits to the consumer, and loss of political freedom. The first 10 years of my career made me passionate about market systems as the best way to meet the economic needs of the population and preserve the most freedom. From my experience, the best solution to most economic needs is to let the market operate more freely. This will produce the most goods at the lowest cost.

Mortgage Broker Market

The mortgage market in the United States is highly competitive—at least that part concerning the origination of mortgage loans. Only those firms that have low costs can compete today. No firm is earning monopoly profits at the expense of the consumer.

Mortgage brokers have evolved fairly recently to meet the needs of consumers. There were only a few operating before 1980. By 1987, they had 20 percent of the market. In 2001, we estimate they had around 65 percent of the market. That is, of the $2 trillion of residential mortgage loans originated, $1.3 trillion were made by mortgage brokers.

Mortgage brokers are the leading channel for the production of mortgages. We estimate there are 33,000 of these small, independent firms today. The median firm has 5 workers, including the owner. The average firm has 9 workers, for a total employment of nearly 300,000 persons. They operate throughout the United States. The median firm is only 5 years old. So, they are quintessentially an industry of small firms competing vigorously with one another. If they do not give the consumer good service, they go out of business. In this sense, they are similar to barber shops. No firm has any special factors with which to exact extra-normal profits from the consumer other than personal service.

Market information is widespread. Any shopper can log onto a computer and get instant market information from thousands of competing firms. Prices also are available in newspapers and television. Mortgages have become a commodity, with very little variation in price among lenders. There are firms out there, especially internet firms, that compete solely on price and offer little human interaction. Up until now, consumers have not flocked to these firms, but have stayed mainly with local brokers who can walk them through the complex process of originating a mortgage. The paperwork to complete a mortgage is highly regulated and complex and must be done correctly. If the loan is not done correctly, the consumer does not get the loan and the loan originator does not get paid.

Fifteen years ago, this industry was dominated by savings and loan associations. Since then, a vigorous secondary market has evolved that allows mortgages to be converted into securities and traded around the world. The tasks to make a mortgage have become specialized. We now have about 100 wholesale mortgage firms buying loans from 33,000 mortgage brokers. Mortgage servicing has become more centralized within the hands of a few larger wholesale firms. But brokers are the low cost producer of the origination process.

The mortgage industry is highly volatile, with periods of high refinancing. Such peak volume years occurred in 1993, 1998, and 2001, when volume nearly doubled from the prior year. It is especially in such years that brokers are needed. The existing retail firms are not equipped to grow their work forces that fast. But brokers are very agile and can grow and contract more quickly to meet the needs of the market. Without brokers, the market would have virtually collapsed last year and many consumers who wanted the opportunity to refinance their mortgage to a lower rate would have been frustrated. There would have not been enough trained workers available to meet their need.

Yield Spread Premiums

The mortgage industry serves the housing industry. It has become national policy to permit as many households as possible to own their own home. The goal is get the share of homeowning households up to 70 percent. The main factor holding back more consumers from buying a house is the downpayment. So the market has evolved several ways to solve that problem—no downpayment or very low downpayment mortgages. It costs about 2 percent of the mortgage amount or $2,800, which is needed to compensate the broker for his cost, time, and profit in originating a mortgage loan. Most buyers today either do not have that amount to pay the origination fee or prefer to finance that fee. The mortgage originator cannot perform his origination function without being paid. From this has evolved the "yield spread premium," which is a way for the homebuyer to retain more of his cash and yet pay the mortgage broker for his service—predominately saving the consumer dollars by refinancing at a lower rate and thereby lowering the consumer's cashflow. Mortgagors are saving on average about $100 per month (assuming a 1 percent reduction in the interest rate from 7.5 percent to 6.5 percent on a $160,000 loan) by enlisting the mortgage broker's services. In today's market, the consumer has the choice of paying all of the fee upfront, part of the fee upfront, or financing the entire fee. The typical homebuyer opts to pay part of the fee upfront. So the income of the mortgage broker in today's market is 55 percent in fees from the consumer and 45 percent in the form of a payment from the wholesaler.

Yield spread premiums are really a financing tool. They became available around 1990 due to securitization. Their availability has spurred mortgage finance and had various spillover effects, including expanding the ranks of homebuyers; increasing refinance activity; growing the ranks of originators, especially brokers; and aiding the economic expansion of the 1990's. In particular, it has helped moderate the current recession by promoting the financing of homes and keeping the housing market vigorous.

If Congress outlawed yield spread premiums, the results would be: (1) fewer mortgage originations, especially among middle- and low-income consumers; (2) higher out-of-pocket expenses for homebuyers and homeowners; (3) fewer mortgage originators; (4) reduced national income and GDP.

Exactly how many fewer mortgage transactions would result with a ban on yield spread premiums is conjecture. We believe the reduction could be 33 percent. A ban would adversely affect mortgagors, and broker mortgagees. There would absolutely be fewer of each group. The declines in each would be proportional. These declines would ripple through the mortgage sector, affecting realtors, builders, appraisers, mortgage insurers, credit bureaus, escrow companies, etc. Mortgage costs would rise due to less competition.

More disclosures would add complexity and cost to a mortgage process which is already extremely confusing to the consumer. Predatory mortgage legislation is probably superfluous. The existing laws protect consumers from being bilked by swindlers and gougers. The number of predatory victims is quite small compared with the size of the mortgage industry. We estimate the number of mortgagors served with a new or refinanced loan at 60 million in the past 5 years. Very few have been harmed. There is no evidence to the contrary. Is it worth harming that huge market with even more laws? Enforcement of existing laws is the answer.

Reaction to HUD Clarification on YSP's

I was present in Toronto, Canada at the MBA annual meeting when Mel Martinez announced his clarification of HUD's policy on yield spread premiums. I support his clarification because it explained the earlier statement HUD made in 1999 to the judiciary and thus should stop class action law suits over the mere payment of yield spreads to brokers. The mortgage industry has been plagued by class action law suits for several years that have cost the industry tens of millions of dollars. Ultimately, these costs are paid by consumers.

Impact on Brokers of Limiting YSP's

I have been a long time supporter of mortgage brokers, who in 2001 handled about 65 percent of all mortgage originations in the United States. They did so because they are the low cost providers. Our firm has studied this issue since 1991 and has been unwavering in its conclusions that brokers provide consumers with better service at a lower cost than their competitors. To restrict brokers is to hurt consumers.

Brokers get half their income in the form of yield spread premiums. I estimate that if yield spread premiums were made illegal, about one-third of all brokers would drop out of the business; and the other two-thirds could survive by charging higher upfront origination fees, but it would dramatically change their customer profile. They would no longer be able to serve as many consumers with credit problems or FHA buyers. That means the market share of mortgage brokers would diminish. This would be very anticonsumer because brokers do a majority of the refinances in years such as 2001. Banks, thrifts, credit unions, and mortgage lenders use the concept of yield spread premium but do not have to report it. Any restriction on YSP's would only adversely affect brokers and have no impact on these other mortgage lenders. In addition, the retail channel (made up by banks, thrifts, etc.) just could not handle the volume. That means in the next refinance wave, many consumers would not get the refinances they desire, certainly not compared to those who refinanced them in the past waves. You would in effect frustrate about one-third of the 7 million households that did refinances, or 2.3 million households. Do you really wish to frustrate that many people? We estimate there are 33,000 independent mortgage brokers processing and originating loans currently within the United States. The average firm has 9 people working for them for a total of 297,000 employees across the brokerage industry. Do you wish to put 99,000 people out of work? In Maryland, there are 550 independent mortgage brokers with total employment of about 5,000 people. Do you wish to put 1,700 Maryland workers out on the street?

Maryland has lost many financial services firms over the past 30 years, including my former firm, Commercial Credit. There was MBNA, Maryland National Bank, Equitable Banks, and Baltimore Federal Savings Bank. In part, the 550 mortgage broker firms in Maryland have replaced the mortgage departments of those once venerable firms. But if Congress bans YSP's, you would put one-third of these brokers out of business also and force further consolidation in the industry. Nor would the consumer be benefited. You would force consumers into the hands of larger firms, mostly based elsewhere, that might charge higher rates and fees. Shrinking the supply given fixed demand would shift supply to the left and the price would, of course, rise. Consumers would pay a higher price consequently.

Impact on Consumers of Limiting YSP's

If yield spreads are eliminated and all consumers have to pay out-of-pocket fees, a large number of lower-income people would be pushed out of the market. This would fall most heavily on minorities. It would lower the portion of households that can become homeowners. Past Administrations have aimed toward 70 percent of all households becoming homeowners. That percentage would have to fall greatly, perhaps back down to 60 percent. As all these transactions are taken out of the market, there are thousands of secondary market impacts—a reduction in credit agents, appraisers, escrow agents, etc. Call them unintended consequences.

What happens when Government protects consumers from borrowing mortgage money? Some loans are not made or the consumer resorts to credit cards and to personal loans at 18–21 percent interest or to hard money lenders at even higher rates of interest. Right now the prime mortgage industry is barely profitable and subprime mortgage lending is unprofitable. There has been an exodus of capital for the past several years. Consumers will not be benefited by causing more lenders to exit.

Disclosures to Curb Abuses

If we mandate even more disclosures, make it the same for all lenders. The problem with asking brokers to estimate their YSP's at time of application is that they do not know what it will be. Until the loan application is complete, they do not know who they will be selling the loan to or what their YSP will be. They can only say that typically they earn half the cost of doing the transaction in that form. This is also true of all other retail lenders, not just brokers but loan originators at banks, thrifts, credit unions, and finance companies too. If you mandate even more disclosure, make it the same for all lenders. I would support uniform disclosures of all mortgage originator payments as a way to curb abusive uses of yield spread premiums to the extent they exist. But I do not think abuses are widespread, as consumers are increasingly sophisticated about financial matters. Doing away with yield spread premiums would not eliminate predatory lenders who thrive on cheating uneducated customers.

Rather than trying to eliminate every vestige of overpricing, Congress should foster more education about loans. Over the past 3 years, over half the firms in subprime lending have shut down. The remaining firms are not very profitable and are trembling not to be sued by the many new laws now on the books. I dare say, very few predatory acts (however these are defined) are taking place. Flipping has hurt Baltimore, but that has little to do with YSP's. Therefore, any new legislation beyond uniform disclosures across the entire industry would be redundant, counterproductive, and against the consumer's best interest. The normal use of a YSP is not predatory lending. It is part of doing business.

PREPARED STATEMENT OF DAVID R. DONALDSON

COUNSEL, DONALDSON & GUIN, LLC

JANUARY 8, 2002

Chairman Sarbanes, distinguished Members of the Committee, thank you for inviting me to testify on the abusive uses of yield spread premiums. By way of introduction, I am a lawyer in private practice in Birmingham, Alabama. I represent the plaintiff class in *Culpepper* v. *Irwin Mortgage Corporation,* a damages suit brought under the Real Estate Settlement and Procedures Act (RESPA). A 1998 Federal court of appeals decision in *Culpepper*[1] led to HUD's 1999 Statement of Policy (SOP).[2] Another decision by that same court in June 2001 resulted in HUD's 2001 SOP[3] that this Committee has asked me to discuss here today.

I would like to begin by expressing my deep appreciation to this Committee for its efforts to examine and curb abusive and deceptive lending practices. The mortgage industry's current yield spread premium practices that are reflected in HUD's 2001 SOP are an integral part of the well-documented predatory problem that is crying out for examination and remedy.

Irwin and many other lenders currently offer brokers yield spread premium payments whenever brokers are able to convince borrowers to accept higher interest rate loans. Consumers are, in effect, being encouraged to borrow money that lenders use to bribe brokers to do business with them. Consequently, brokers who have been fully compensated by loan origination fees and other "direct" payments also receive unearned additional "compensation" that costs homeowners thousands of additional dollars in mortgage payments over the duration of their loans.

RESPA outlaws all kickbacks and referral fees.[4] Under *Culpepper,* a yield spread premium can be legal if the evidence demonstrates that the yield spread premium was paid in exchange for the broker's services.[5] HUD's 2001 SOP seeks to delete the "for services" requirement and thereby legalize "reasonable" referral fees even when no additional compensation is owed to the broker. I believe HUD's recent actions to be misguided, irrational, and in direct conflict with Congress's express intent in passing RESPA.

Yield Spread Premiums Are Not Being Used To Lower Closing Costs

HUD's ostensible reason for the 2001 SOP was its claim that *Culpepper* might prevent borrowers from using yield spread premiums to lower their upfront closing costs.[6] The court's Culpepper decisions, however, expressly allow borrowers to finance closing costs through yield spread premiums.[7] A yield spread premium could be legal under Culpepper III if the lender's form contract with the mortgage broker required the broker to use the yield spread premium payment to reduce borrowers' upfront closing costs.[8]

HUD's and the industry's "consumer benefit" arguments are clearly "red herrings." Under HUD's "reasonableness test," YSP's are legal regardless of whether they are used to lower closing costs. Moreover, lenders and brokers do not, in fact,

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[1] *Culpepper* v. *Inland Mortgage Co.,* 132 F.3d 692, *rehearing denied,* 144 F.3d 717 (11th Cir. 1998).

[2] 64 Fed. Reg. 10080.

[3] 66 Fed. Reg. 53052.

[4] This Committee's 1974 Report issued in connection with the original RESPA litigation, states that RESPA is intended to "prohibit all kickback or referral fee arrangements whereby *any payment* is made . . . for the referral of real estate settlement business." S. Rep. No. 93–866, 1974 U.S.C.C.A.N. 6546, 6551.

[5] See *Culpepper* v. *Inland Mortgage Co.,* 132 F.3d 692, *rehearing denied,* 144 F.3d 717 (11th Cir. 1998). The 1999 SOP states: "In the determination of whether payments from lenders to mortgage brokers are permissible under Section 8 of RESPA, the threshold question is whether there were goods or facilities actually furnished or services actually performed for the total compensation paid to the mortgage broker." 64 Fed. Reg. at 10085.

[6] The text of the 2001 SOP, as well as the Secretary's news release announcing that pronouncement justified the SOP on the grounds that "[y]ield spread premiums serve to allow the borrower a lower upfront cash payment in return for a higher interest rate. . . ." *See* 66 Fed. Reg. at 53055; *see also* HUD News Release No. 01–105.

[7] *Culpepper I,* 144 F.3d at 718.

[8] A yield spread premium is legal under *Culpepper III* "if the agreement to pay it bore the hallmarks of a fee-for-service exchange." *Culpepper III,* 253 F.3d at 1331.

use yield spread premiums to lower borrowers' closing costs. At the outset of the *Culpepper* litigation, Irwin claimed that "the yield spread premium was simply the market-driven payment to [the broker] for an asset—the loan itself."[9] It was only after the courts rejected that argument that industry lawyers concocted the idea that yield spread premiums were used to lower borrowers' closing costs. My colleagues and I have examined thousands of Irwin's borrowers' loan documents, and I have yet to find a single class member whose closing costs were reduced as a result of yield spread premiums. Among class members in other cases, I am only aware of a tiny handful of settlement statements reflecting credits against the borrowers' obligations resulting from yield spread premiums.[10]

If yield spread premiums were actually being used to lower borrowers' closing costs, the lenders could expect to prevail in the litigation. Indeed, if they are not violating the law, they will prevail in court. But it is highly improper for HUD to attempt to overrule the courts, alter the plain meaning of Congress' statute, and, indeed, interfere with both procedural and evidentiary issues in the judicial system. HUD has no such power, nor should it.

HUD's 2001 SOP Does Nothing To Curb Abusive YSP Payments

HUD and mortgage industry representatives have publicly admitted that mortgage brokers frequently tack on unexpected charges at closing when it is too late for borrowers to obtain other financing.[11] This should come as no surprise since the National Association of Mortgage Brokers (NAMB) takes the position that brokers should be allowed to hide yield spread premiums from borrowers.[12] While the *Culpepper* court's "fee for services" approach would help curb these nefarious "bait and switch" tactics, HUD's "reasonableness" test encourages brokers to tack on additional charges at closing. Since the "reasonableness" of a charge is measured by what other brokers charge, no referral fee or kickback can be illegal under HUD's test as long as the practices are widespread.

HUD's "Reasonableness" Test Amounts to Illegal Rate Regulation

When Congress passed RESPA, it expressly rejected HUD's proposals for authority to impose caps on settlement charges. Congress chose to allow the market to set prices and rejected HUD's request for a "large bureaucracy" within HUD to set rates for various types of loans in various locales.[13] Since HUD lacks the legal authority and the staff to set caps on settlement charges for various loans, it surely cannot examine millions of individual loan transactions to determine if individual broker payments are "reasonable." HUD's "reasonableness" rule ignores the fact that allowing the "market" to set prices is a two-way street. If brokers are free to set their own charges, they must also be prohibited from collecting more than borrowers agree to pay.

The 2001 SOP Test For Yield Spread Premium Payments To Brokers Is Inconsistent With The Test For Other Types of Markups by Other Settlement Service Providers

The 2001 SOP is also internally inconsistent in the way it treats yield spread premium payments to mortgage brokers as opposed to other types of mark-ups charged by other service providers. While imposing a "reasonableness" test for YSP payments to brokers, the 2001 SOP states that other settlement service providers violate RESPA whenever they mark up the cost of a third party's services without providing additional settlement services over and above the services for which the pro-

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[9] *Culpepper* v. *Inland Mortgage Corp.,* 953 F.Supp. 367, 371 (N.D. Ala. 1997).

[10] The HUD–1 Settlement Statements required by RESPA and HUD to be delivered at closing is required to reflect credits against closing costs for payments made by the lender on the borrower's behalf if any were given.

[11] In HUD's Press Release No. 01–105 announcing the 2001 SOP, Secretary Martinez stated: "At closing, too many American families sit down at the settlement table and discover unexpected fees that can add thousands of dollars to the cost of their loans." In the December 23, 2001 edition of *The Los Angeles Times,* Mr. Falk, who is testifying here today on behalf of the National Association of Mortgage Brokers, was quoted as stating that "horror stories abound of borrowers arriving at closing to find that [the] actual cost of various services are hundreds of dollars above what was disclosed on the Good Faith Estimate."

[12] During HUD's negotiated rulemaking on yield spread premiums that led up to its 1997 proposed rule for providing for binding contracts between brokers and borrowers, the NAMB argued "strenuously" that yield spread premiums should not be disclosed to borrowers. *See* 62 FR at 53917. In the NAMB's December 4, 2001 Position Paper entitled "Mortgage Originator Disclosures—Position on Prospective HUD Rulemaking Concerning Mortgage Originator Disclosures" (available on the NAMB's website *www.namb.org*) has an entire section (at ¶4) devoted to its contention that "Originators should not be required to disclose their compensation."

[13] *See* 1974 U.S.C.C.A.N. at 6550.

vider has already been paid.[14] For example, the 2001 SOP states that a RESPA violation occurs when a lender collects $200 from the borrower for an appraisal fee, pays an independent appraiser $175 and pockets the $25 mark-up.[15] The "reasonableness" of the $200 charge is presumably irrelevant. HUD has recently (and with great fanfare)[16] brought several RESPA enforcement actions arising from a variety of contexts unrelated to yield spread premiums. None of these recent enforcement actions would have been possible under HUD's "reasonableness" test for yield spread premiums. Conversely, under the test applied to appraisals and other settlement charges, if a broker charges a loan origination fee and then marks up a borrower's interest rate a RESPA violation would occur. There is no legal or logical basis for this inconsistent treatment.

HUD Has Tacitly Admitted That Its 2001 SOP Is Inadequate To Protect Consumers

HUD recognizes that its "reasonableness" test is inadequate to protect borrowers. On the same day that HUD released its 2001 SOP, it also sent a letter[17] to all FHA approved lenders setting out HUD's views on "best practices" regarding yield spread premiums. HUD urges lenders to disclose the total amount of the broker's compensation, including the yield spread premium and to obtain a written acknowledgment by the borrower. HUD also suggested that lenders reflect yield spread premiums as credits on borrower's HUD–1's.

HUD's Claim That The 2001 SOP Is A "Clarification" Is Unsupportable

HUD's claim that the 2001 SOP reflects its earlier intent is disingenuous. In the 1999 SOP and in correspondence between HUD's former General Counsel and Members of Congress, including a Member of this Committee, HUD expressly stated that the 1999 SOP was not intended to change existing law, which was expressed in the appellate court's previous *Culpepper* decisions.[18]

Five years ago when the *Culpepper* case was filed, Irwin did not even require brokers to disclose yield spread premium amounts on borrowers' Good Faith Estimates. It was not until after the 1998 *Culpepper* decision that Irwin began requiring brokers to disclose yield spread premium amounts on GFE's. Although the industry has been forced by the ongoing yield spread premium class action litigation to make at least minimal yield spread premium disclosures to consumers, much more is needed if consumers are to be able to have any hope of protecting themselves in mortgage loan originations.

Obviously, HUD is correct in the view expressed in its recent mortgagee letter that brokers should disclose their total compensation and that borrowers should be given credit against whatever is owed to the broker when the broker receives a yield spread premium. Even with that disclosure, however, it is doubtful that any but even the most sophisticated borrower could make an informed decision about yield spread premiums without additional disclosures being required. To make an informed decision about yield spread premiums, borrowers would also have to know how much their rates are being increased to generate the yield spread premium and have to know how much additional monthly interest payments they would incur as a result of the markup. Moreover, in order to prevent unscrupulous brokers from overcharging and to prevent borrowers from "bait and switch" tactics where yield spread premiums are disclosed for the first time at closing on the HUD–1, HUD must require the mortgage industry to use yield spread premiums to lower closing costs as it now claims to be doing.

Finally, I would be remiss if I failed to point out my personal opinion that current yield spread premium practices encourage discrimination. After spending 5 years of looking at numerous borrowers' closing documents it is clear to me that borrowers who are black, female, or Hispanic pay higher total broker "compensation" than white males. That opinion is also supported by a recent Urban Institute Study financed by HUD which found that "[t]here is no question that minorities are less likely than whites to obtain mortgage financing and that, if successful, they receive less generous loan amounts and terms." HUD News Release, No 99–191, *New Reports Document Discrimination Against Minorities by Mortgage Lending Institutions,* at 1 (September 15, 1999). The Urban Institute Study also found that African-Americans and Hispanics tend to pay higher YSP's than whites and that women pay more than men. Urban Institute Study at 95 n. 11. One of the *Culpepper* plaintiffs,

[14] *See* 66 Fed. Reg. at 53059.
[15] *See* 66 Fed. Reg. at 53058.
[16] *See* HUD Press Release No. 01–118.
[17] Mortgagee Letter 2001–26 (available on HUD's website).
[18] *See* attached letter from Gail Laster to Senator Richard Shelby dated March 21, 2000.

Beatrice Hiers, is an African-American female from Baltimore whose broker received over $10,000 for assisting in her origination of a $160,000 FHA mortgage. The $4,500 YSP would never have been paid under the *Culpepper* rule. According to Irwin, that payment was legal because it was "reasonable."

Federal regulators require banks and other depository institutions to implement safeguards to prevent racial and other types of discrimination by their employees. Mortgage brokers, however, are often nothing more than an individual or small group of individuals acting as independent contractor loan officers. They are not subjected to any oversight by institutional lenders or by regulators. Current yield spread premium practices that base "compensation" on the broker's ability to convince borrowers to accept higher interest rates encourage discrimination.

Thank you again for inviting me and for your attention to these important issues.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM HOWELL E. JACKSON

Q.1. During the hearing, Mr. Olson said that the mortgage brokerage business "is not very profitable." Do you have any information on the profitability of the mortgage broker industry?

A.1. While I have not undertaken an independent investigation of the profitability of the mortgage brokerage business, I reviewed several reports on the subject that Mr. Olson himself prepared. Contrary to Mr. Olson's testimony at the hearing, these reports indicate that mortgage brokers have been extremely profitable in the past decade and, in particular, during the 1996–2000 period during which the sample loans in my study were originated.

To begin with, consider the growth of mortgage brokers. According to Mr. Olson's Wholesale Access Report: Mortgage Brokers 1998 (published in 1999), the industry grew dramatically during the 1990's:

> There were about 36,000 mortgage brokers in the United States in 1998, up from 14,000 in 1991 and 31,000 in 1997. There was a 14.5 percent average annual rate of growth in the number of brokers from 1991 to 1998, which is parallel to the 15 percent average annual growth in originations over the same period. (Page 1)

Without any further information, I would be skeptical of any claims that an industry experiencing such a sustained rate of growth "is not very profitable." If the industry were not profitable, why would so many new firms have been established during the last decade? However, one does not have to rely on inferences to assess the profitability of mortgage brokers in the 1990's. Mr. Olson's report directly addresses the issue:

> The median broker produced $20 million, had 5 employees, produced 200 loans, earned $2,000 gross per loan, for a total revenue of $400,000 per firm. In 1991, the median broker produced $15 million with 5 employees. (Page 1)

So while the number of mortgage brokers more than doubled between 1991 and 1998, the level of originations of the median firm also increased by a third.

Finally, Mr. Olson's report offers the following evaluation of the profitability of the mortgage brokerage business in 1998:

> The median broker earned $2,000 gross income/loan for 200 loans, which means gross revenue of $400,000 (Table 94). The mean broker earned $2,443 gross income/loan for 325 loans, which means gross revenue of $794,000. Median expenses were $240,000, for a net profit of $160,000 (40 percent). The mean broker earned a profit of $203,000 on $794,000 (26 percent). Our study covering 1992 shows a median profit of $100,000 on revenue of $400,000. *This suggests a higher rate of profit in 1998 than earlier*. Since brokers are rarely C Corporations, they do not pay a corporate profits tax. They do however pay taxes at their lower personal rate. This suggests a total profit by brokers of $7.3 billion (36,000 × $203,000) before taxes. This exceeds the amount earned by the two Federal agencies combined and much of the rest of the mortgage industry. (Page 14) (Emphasis added).

As the median firm operates as a sole proprietorship, Mr. Olson's report suggests that a typical mortgage broker earned $160,000 in 1998—an extraordinary median level of income for an industry that does not require substantial training or advanced degrees.

Last year, Mr. Olson issued an updated Whole Access Report: Mortgage Brokers 2000 (published in 2001). In connection with litigation for which I am serving as an expert witness for the plaintiff class, I have reviewed a copy of this more recent report. However, the 2000 report was supplied to me under conditions of confidentiality and I am not free to reveal to the Committee the detail of Mr. Olson's more recent work. I can, however, provide the Committee my overall assessment of the 2000 report. While there have been some changes in the structure and the earnings of mortgage brokers since 1998, I am highly confident that Mr. Olson would concur in my opinion that there is little in this more recent report to suggest that mortgage brokering does not remain a profitable enterprise.

Q.2. In your view, is the 2001 HUD "clarification" consistent with the law, and should the courts give it deference?

A.2. In the 2001 policy statement, 66 Fed. Reg. 53,052 (October 18, 2001), the Department proposes a legal standard to determine when the payment of yield spread premiums violates Section 8 of RESPA. Under the Department's approach, a yield spread premium constitutes a *per se* violation of Section 8 only if the mortgage broker receiving the payment provides no goods or services in connection with the transaction. If the mortgage broker does provide either such goods or services, then the payment is legal unless the borrower can demonstrate that the broker's total compensation was unreasonable. Reasonableness, under the Department's policy statement, is to be determined on a case-by-case basis and not (by implication) in a class action lawsuit.

In my testimony before the Committee I questioned the factual assumptions underlying the Department's 2001 policy statement.[1] I also have serious questions about the policy statement's fidelity to the statutory language of Section 8 of RESPA. In my view, there are three principal difficulties in the Department's legal analysis.

The Policy Statement Appears to Create a Loophole for the Market Abuses That Congress Clearly Intended for Section 8 To Eradicate

In the legislative process leading up to the original passage of RESPA in 1974, Congress was confronted with substantial evidence that real estate professionals, such as lawyers and real estate agents, were using their influence over real estate transactions to extract kickbacks from title insurance companies and other settlement service providers. Concluding that such payments were inherently unfair and needlessly increased the cost of homeownership, Congress adopted Section 8 to outlaw these practices. A major difficulty with the Department's 2001 policy statement is that it appears to create a substantial defense for precisely the practices that Congress intended to prohibit with Section 8. All of the recipients of these pre-RESPA kickbacks provided some good or service for the transaction in question and also received other sources of compensation for their services. The Department's new policy statement would, as best as I can tell, permit the payments of kickbacks

[1] As I explained in my testimony, an initial problem with the policy statement is the Department's factual assumptions that yield spread premiums are simply an alternative source of financing for closing costs used by a discrete group of borrowers who cannot afford to pay those costs directly. My own study of yield spread premiums suggests that these payments are being imposed much more broadly and that borrowers who incur these hidden charges end up paying their mortgage brokers much more—on the order of $1,000 more—than do borrowers with comparable loans unaffected by yield spread premiums. The Department's misunderstanding of the true role of yield spread premiums further weakens the legal basis of the policy statement.

in real estate settlements unless the recipient of the kickback could show that its total compensation (including the kickback) was not unreasonable. Such solicitude for the payment of kickbacks is wholly inconsistent with Congress's purpose in enacting Section 8 of RESPA.

The Department's 2001 Policy Statement Establishes a Regime of De Facto Rate Regulation for Mortgage Services in Direct Contradiction of Congressional Intent

When adopting RESPA in 1974, Congress expressly rejected the proposals to establish a national system of rate regulation for real estate settlement services and chose instead a combination of prohibitions, such as Section 8, and disclosure requirements. With its 2001 policy statement, the Department effectively repeals this Congressional choice. As I read the policy statement, courts would be called upon to evaluate the legality of most kickbacks and referral fees based on the reasonableness of the total compensation of the recipient. While the Department does not delineate the precise contours of this reasonableness standard, the courts would presumably have to consider a kickback recipient's total costs, figure in reasonable rates of return on investment, and come up with an overall reasonable price for the recipient's goods and services in light of contemporaneous market prices for other comparable goods and services. Congress clearly did not want a Federal administrative agency to engage in this rate regulation, and I am highly doubtful that it would have intended for the courts to play such a role.

The Policy Statement Gratuitously Intrudes Upon Judicial Functions

A further problem with the 2001 policy statement is its gratuitous intrusion into the management of judicial cases. In an apparent effort to influence the certification of plaintiff classes in pending cases, the 2001 policy statement includes language suggesting that "it is necessary to look at each transaction individually" and that reasonableness depends on an evaluation of factors that can only be considered on a case-by-case basis. This analysis strikes me as misguided and inconsistent with prevailing judicial practices. First of all, reasonableness in a particular case can only be determined in comparison to a broader category. Of necessity, therefore, litigation over yield spread premiums will involve consideration of a large number of transactions. And the best way to determine whether loans with yield spread premiums entail unreasonable compensation to mortgage brokers is to compare samples of loans with yield spread premiums to samples without yield spread premiums.[2] To require repeated analysis of this sort in a host of individual cases strikes me as a highly wasteful use of judicial resources. Moreover, the Department's approach seems to confuse the question of how much individual borrowers were injured through the payment of illegal kickbacks—something that might well vary from transaction to transaction and thus potentially influence the

[2] In the litigation in which I am serving as an expert witness, experts for both sides defendants as well as plaintiffs—used this statistical—analysis to evaluate the impact of yield spread premiums on mortgage broker compensation.

amount of damages—with the question of underlying liability. In many areas of the law, courts determine liability on a class-wide basis and then base damage awards on individualized determinations. Whether class certification would also be appropriate for civil suits challenging yield spread premiums under Section 8 of RESPA strikes me as a matter for the court, not an administrative agency, to resolve.

How much deference the Federal courts should accord the Department's 2001 policy statement is an important question that I did not address in my testimony before the Committee and that I will only briefly touch upon in this supplemental statement. As described above, I believe there are serious inconsistencies between the 2001 policy statement and the Congressional purposes in enacting Section 8 of RESPA. To the extent that the courts agree with my analysis of these issues, the policy statement would be subject to diminished deference even under the high standards that the Supreme Court set forth in *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council,* 467 U.S. 837 (1984). Just last year, however, the Supreme Court narrowed the scope of the *Chevron* doctrine by holding that when an agency interpretation is not the product of either formal adjudication or notice-and-comment rulemaking, the *Chevron* deference standards may not even apply. See *United States* v. *Mead Corporation,* 533 U.S. 218 (2001). While the implications of the Court's recent ruling remain to be determined, I think it is fair to say the decision reduces the degree of deference that Federal courts are likely to show interpretative rulings such as the Department's 2001 policy statement. Particularly to the extent that the policy statement purports to dictate the manner in which the judiciary should manage class certification procedures, judicial deference to the agency's view should be modest. See *Adams Fruit Co.* v. *Barrett,* 494 U.S. 638 (1990) (inappropriate for courts to consult executive interpretations to resolve ambiguities in the scope of a judicially enforceable remedy).

Q.3. Currently, when individuals apply for loan assistance or a home mortgage, they are unaware of their credit scoring, and are therefore, under the Fair Credit Reporting Act (FCRA), vulnerable to acts of predatory lending including taking on a mortgage with a high-interest rate even though their credit score may qualify them for a low-interest loan. I think this is a serious issue, and Senator Allard and I have introduced the Consumer Credit Score Disclosure Act of 2001, which amends the FCRA to provide the consumer with a copy of: (1) the information obtained from a consumer reporting agency or that was developed and used by that user of the credit score information; or (2) a copy of the information provided to the user by a third party that developed the credit score, plus a general description of credit scores, their use, and the sources and kinds of data used to generate credit scores. As an expert testifying before the Committee, would you agree, that individuals should have access to their credit score in order to protect themselves from acts of predatory lending?

A.3. Yes. I agree that it would be useful for consumers to be given access to their credit scores. In addition, as I indicated in my testimony, I think consumers should also be provided information regarding the range of loans—including par value loans—available to borrowers with their credit scores. In addition to improving the fairness of loan transactions, disclosures of this sort would allow consumer groups and the financial press to provide better guidance to borrowers and thereby enhance the overall operations of credit markets.

* * * * *

Response to the Statement of ABN AMRO Mortgage Group

Following the Committee's hearing of January 8, 2002, ABN AMRO Mortgage Group filed a statement disagreeing with certain aspects of my testimony and appending statements by two expert witnesses retained by defendants in the *Glover* v. *Standard Federal Bank* litigation in which I am serving as an expert for the plaintiffs. Having reviewed these materials, I remain confident that my testimony before the Committee presents an accurate picture of the abusive nature of yield spread premiums, that these payments impose substantial additional costs on consumers, and that the reforms I advocated for HUD–1 disclosures are fully warranted.

RESPONSE TO WRITTEN QUESTION OF SENATOR SCHUMER FROM JOSEPH L. FALK

Q.1. As an expert testifying before the Committee, would you agree, that an individual should have access to their credit score in order to protect themselves from acts of predatory lending?

A.1. NAMB strongly believes that all consumers should have access to their credit score in order to know where they stand in the eyes of the lender, and to better understand how one's credit history can affect his/her ability to purchase and own a home. We do not believe accessibility should be a function of whether the individual is a candidate for a prime or subprime loan, but instead, available to any and all consumers seeking to obtain a mortgage. More than just words, NAMB has taken tangible steps to help educate consumers about the importance of one's credit score. On November 19, 2001, NAMB released an educational piece entitled, "Buying A Home . . . How Will Your Credit History Affect You?" This is part of NAMB's efforts to encourage consumers to "Know the Score." The article identifies the five key criteria used in determining a credit score and lets consumers know that they can receive a copy of "A Consumer's Guide to the Facts & Fiction About Credit Scoring and Its Role in Lending" from any NAMB mortgage broker member.

PRESS RELEASE

8201 Greensboro Drive, Suite 300, McLean, VA 22102 (703) 610-9009 www.namb.org

For Immediate Release

Contact: Natalie Bachiri
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Buying a Home...How Will Your Credit History Affect You?

National Association of Mortgage Brokers Encourages Consumers to 'Know the Score'

November 19, 2001—You've checked out the neighborhood, determined how much you can afford to spend on a mortgage payment and decided where to go to obtain a loan. What you might not have done is consider your personal credit history and how it might affect your ability to borrow money for that home you want to purchase.

Your credit score (FICO score) is a quick, accurate and consistent scientific method of assessing your credit risk. Based upon data stored with a credit repository, your credit score is a snapshot that sums up what your past payment performance and current usage of credit say about your level of credit risk to the lender.

A credit score is a number ranging from 300 to 900, with a score of 620 or more leaning toward the best-priced loan products. Consumers with scores that fall below the desired range are still likely to obtain a loan, however, they may not receive an interest rate that is as favorable as a borrower with a higher credit score because the risk is greater.

The question is, what determines a credit score? Credit scores are generally based on current debts, balances and payment history including mortgages, credit cards, auto loans, collections, judgments, tax liens and bankruptcy filings. Credit scores are not based on race, gender, religion, marital status, income, nationality, neighborhood, employment history or interest being charged on a particular credit card.

A credit score is based on five criteria:

1. **Past payment performance** – the fewer late payments, judgments, liens or collections, in the last 24 months the better. The more recent, even a 30-day late is reported in a credit file, the greater the negative impact on the score. Past dues will kill credit scores.

- more -

2. **Credit utilization** – low balances on several credit cards are better than high balances on a couple of cards. Balances on your credit cards should be kept below 30 percent of your maximum available credit limit. Maxed-out credit card balances kill credit scores.
3. **Credit history** – the longer your accounts have been active, the easier it is to determine how disciplined a consumer is in managing his credit. "Credit card surfing," opening new accounts and closing your seasoned accounts, can negatively impact your score.
4. **Types of credit in use** – finance company accounts can score lower than accounts you secure through banks or department stores. "90 days same as cash" and deferred payments generally are funded by finance companies.
5. **Inquiries on your report** -- looking for new credit can indicate higher risk if several credit cards are applied for in a short period of time and your existing cards have been maxed out. One or two inquiries alone will not significantly drop an individual's credit score to unacceptable limits.

"Financing the purchase of a new house or refinancing your home can be a complicated process," says Ginny Ferguson, CMC, secretary of the NAMB Board of Directors and chair of the association's Credit Scoring Committee, "and credit scoring is one of the biggest question marks in the process for the consumer. Contact your local mortgage broker to have them run a tri-merged credit report for you. Ask them to review the information for accuracy with you, and explain how it impacts your score. With assistance from your mortgage broker, you can be sure your credit profile is fairly and accurately represented and that your scores are being calculated on accurate information. Smart, advanced preparation can enable your mortgage broker the ability to provide you access to the widest variety of appropriate loan products."

In order to ensure the highest credit score, consumers are encouraged to review their credit on an annual basis to make sure all information is accurate.

Consumers can get a copy of "A Consumer's Guide to the Facts & Fiction About Credit Scoring and Its Role in Lending" from a NAMB mortgage broker member who can assist them with all of their mortgage financing needs. To find a mortgage broker in your area, go to the Find a Broker section of the NAMB website at www.namb.org.

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The full press release is available in NAMB's media center online at **www.namb.org/media_center.htm**

The National Association of Mortgage Brokers (NAMB) is the voice of the mortgage broker industry with more than 13,000 members and 41 affiliated state associations throughout the country. NAMB provides education, certification and governmental affairs representation for the mortgage broker industry, which originates more than half of all residential loans in the United States.

RESPONSE TO WRITTEN QUESTION OF SENATOR SARBANES FROM DAVID R. DONALDSON

Q.1. In your view, is the 2001 HUD "clarification" consistent with the law, and should the courts give it deference?

A.1. No. HUD's 2001 "clarification" regarding yield spread premium payments is inconsistent with RESPA's plain language and its legislative intent. The courts should not afford HUD's SOP 2001–1 any deference.

Section 8(a) of RESPA expressly outlaws all referral fees, not just "unreasonably" high referrals fees.[1] HUD and the courts have recognized that yield spread premiums violate Section 8 of RESPA unless they fall within the "goods or services" language of Section 8(c), which states that RESPA does not prohibit "payment for goods or facilities actually furnished or for services actually performed . . ." 12 U.S.C. § 2607(c) (Emphasis added.) Thus, for a yield spread premium to be legal under RESPA, the lender must demonstrate that the yield spread premium was paid for legitimate "services" other than the referral of the loan.

HUD's 1999 SOP on yield spread premiums contained the same "for services" requirement that is set out in the statute. HUD's 2001 SOP, however, deleted the statute's "for services" language. According to the 2001 SOP, yield spread premium payments are legal so long as the amount of money received by the broker is "reasonable." 66 Fed. Reg. at 53055. There is nothing in the statute to support HUD's conclusion that "reasonable" referral few are legal. As this Committee pointed out in its 1974 Report issued when Congress first enacted the statute, RESPA was intended to "prohibit *all* kickback or referral fee arrangements whereby *any payment* is made . . . for the referral of real estate settlement business." S. Rep. No. 93–866, 1974 U.S.C.C.A.N. 6546, 6551 (Emphasis added.)

When Congress passed RESPA, it rejected proposals to allow HUD to determine when rates are too high. Congress chose to allow an open and honest market to set prices and rejected HUD's request for a "large bureaucracy" within HUD to set rates for various types of settlement services in various locales. *See* 1974 U.S.C.C.A.N. at 6550. Nonetheless, HUD has now unilaterally attempted to grant itself the power it was denied by Congress to regulate the "reasonableness" of broker payments. HUD's 2001 SOP is clearly illegal and inconsistent with RESPA. HUD lacks the authority to set "reasonableness" caps that allow brokers to charge borrowers more than the borrowers agreed to pay.

RESPA carries criminal as well as civil penalties. Yet HUD's 2001 "reasonableness" test is so vague and ambiguous that it could never withstand a constitutional challenge. As the Court of Appeals pointed out, by focusing entirely on the agreement between the broker and borrower and ignoring the lender's purpose in making the yield spread premium payment, the "reasonableness" test would place the lender in the "bizarre position of not knowing

[1] Section 8(a) of RESPA states:

No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a Federally related mortgage loan shall be referred to any person.

whether its conduct was illegal when it committed it." *Culpepper* v. *Irwin Mortgage Corp.,* 253 F.3d 1324, 1331 (11th Cir. 2001).

I also believe that the 2001 SOP is invalid due to HUD's failure to comply with the requirements of Section 8(c)(5) of RESPA, which allows HUD to make RESPA interpretations by regulation after consulting with the Attorney General, the Secretary of Veterans Affairs, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Secretary of Agriculture. The 2001 SOP was not adopted by regulation. Nor did HUD consult with other agencies before issuing the SOP.

HUD's 2001 SOP is based on the misconception that the purpose of yield spread premiums is to allow borrowers to lower their "direct" closing costs, such as loan origination fees. That idea is pure fantasy. It is an argument dreamed up in the course of this litigation after the Court of Appeals rejected Irwin's claim that YSP's are compensation for above-par mortgages. Not one shred of evidence has been submitted in any of the yield spread premium cases to support this fallacious premise. Indeed, it is my understanding that mortgage industry representatives were unable to locate a single borrower who was helped by the use of yield spread premiums to testify at the hearing on January 8 conducted by this Committee from among the millions of borrowers whose brokers have received YSP's.

Lenders offer YSP's for one reason only, to encourage brokers to send them business. Mr. Olson who testified as a mortgage industry expert at this Committee's January 8 hearing, has admitted under oath that he has conducted studies to determine the amount of yield spread premium that lenders must offer to obtain broker referrals. Likewise, Standard Federal's Jeff Conner candidly admitted that Standard Federal offers yield spread premiums "to get business." Numerous witnesses in the Standard Federal case have now admitted that the YSP's are nothing but a program of inducements to brokers to refer loans to Standard Federal or its subsidiaries rather than to some competing lender. Others admit that the lender is merely buying high-yield loans by offering the broker a financial inducement to lock borrowers into high mortgage rates. Similarly, in the *Culpepper* case, Irwin admitted that the broker was owed no "additional compensation" for its services and that "the yield spread premium was paid to [the mortgage broker in part] for the slightly above-par yield on the mortgage note and [in part] for the right to service the loan." *Culpepper* v. *Inland Mortgage Corp.,* 132 F.3d 692, 697–98 (11th Cir. 1998). Copies of some of the Standard Federal testimony is enclosed. I can readily furnish additional testimony if you desire it.

HUD's 2001 SOP is also based on the misconception that the Eleventh Circuit Court of Appeals' *Culpepper* decisions made all yield spread premiums illegal. Nothing could be further from the truth. The *Culpepper* decisions made it crystal clear that borrowers may legally use YSP's to finance closing costs and that lenders may pay YSP's if their contracts with the brokers provide for additional compensation for the broker's legitimate services.[2] The difference between HUD's approach and the statute as interpreted by the Eleventh Circuit is that the *Culpepper* court's decision limits YSP payments to situations where brokers are owed additional compensation. HUD, on the other hand, now advocates allowing brokers to charge more than borrowers agree to pay.

HUD's 2001 policy statement is fundamentally inconsistent with RESPA's referral fee prohibition. HUD has no power to interpret RESPA in a manner that frustrates the statute or the policy underlying the statute. HUD's 2001 policy statement violates this fundamental rule and is accordingly not entitled to any deference by the courts.

RESPONSE TO WRITTEN QUESTION OF SENATOR SCHUMER FROM DAVID R. DONALDSON

Q.1. As an expert testifying before the Committee, would you agree that individuals should have access to their credit scores in order to protect themselves from acts of predatory lending?

A.1. I agree that borrowers should be provided with a copy of all information provided by the consumer reporting agencies to third parties along with information explaining how credit scores are calculated and used. If lenders are forced to stop offering illegal incentives for brokers to jack up people's interest rates and if brokers are forced to provide credit scoring information to borrowers, borrowers will have a "fighting chance" to avoid being tricked into originating "above-par" mortgages that cost them millions of dollars in unnecessary interest payments.

[2] However, as Professor Jackson pointed out in his testimony before the Committee, using YSP's to finance closing costs often results in a shockingly high interest rate on the small increment of additional money that is credited to the borrowers.

UNITED STATES DISTRICT COURT

DISTRICT OF MINNESOTA

FOURTH DIVISION

LONNIE GLOVER AND DAWN GLOVER,

PLAINTIFFS,

VS. CIV. NO. 97-2068 DWF/BRN

STANDARD FEDERAL BANK, ABN AMRO MORTGAGE GROUP, INC., AND HEARTLAND MORTGAGE,

DEFENDANTS.

DEPOSITION

OF

DAVID A. OLSON

JULY 12, 2001

RICHARD K. AUGUSTINE, COURT REPORTER
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A (Witness complying.) Okay.

(OFF THE RECORD.)

BY MR. GILL:

Q You're discussing at the top of page 10 how much of an increase in price is needed by the brokers to get them to switch wholesalers, right?

A Correct.

Q Now, what that means is that a broker who's doing business – oh, let's take one of these that's listed in your thing here and say it's First Union. And that's a wholesaler, isn't it?

A Correct.

Q And if Standard Federal wants them to switch wholesalers to Standard Federal, one of the ways to do it is to increase the price, right?

A No, that the interest rate would have to be superior – yeah, they could pay – let's look at page 47.

Q No, let's look what you said at the top of page 10.

A The original document is page 47.

Q 47? 46?

A Isn't it Table 47?

MS. SAVAGE: I'm sorry, could we have, the question again? I lost it.

Q I agree, because the witness didn't answer the question. The question is one of the ways the

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wholesaler gets the broker to switch wholesalers is to offer him a higher price for the loans?

A Correct.

Q Okay. And you did a study to see what incremental price increase you have to offer to get the average broker to be willing to make that switch?

A Correct.

Q And you concluded, in Table 46, if you'll flip to it with me.

A Uh hum.

Q That the largest number of them, a third approximately, 33.1 percent, would switch for a quarter of a point, right?

A Correct.

Q So that if Standard Federal wanted to get the brokers to switch from First Union to them, they could get a good many of them by offering an additional quarter of a percent?

A Correct.

Q On the price. Now this whole survey only had 662 brokers, right?

A No. It had – those are the number that responded to that question.

Q Okay, that's fair.

A It had about a thousand.

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Q No, that's a fair distinction. The number that answered that question out of the what?

A Approximately a thousand.

Q But there are 30,000 brokers nationwide?

A Correct, correct.

Q So you got responses from 662 to this question?

A Correct.

Q And almost an additional third would move for a half a point additional price, right?

A Correct.

Q And we talked earlier about a Jack-o-lantern special. If brokers are not sending Standard Federal enough loans at Halloween, or the month of October, and they want to induce some more of them, this study would tell them that they can probably get a substantial pick up in the referrals by offering 25, .25 percent more money, right?

MS. SAVAGE: Object to the form of the question?

A It's the price on the loan, they would offer higher, yeah.

BY MR. GILL:

Q And the way they add to the price is one of these specials typically? That's one way to do it, right?

A Well, it might be. But more typically they would

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just, they are going to be generally in the market. I don't think there are that many holiday specials, I haven't heard that much talk about holiday specials.

Q You mean you've missed out on the Jack-o-lantern special, the Jingle Bell special, the End of May special, the Firecracker special? I don't know, they go on and on. You haven't heard much about those?

A Haven't heard a lot about those.

Q The Turkey Trot special, the June Bug special? You haven't heard about all that in your conversations with brokers?

A No, I haven't. We just talk about pricing and what it takes and how much difference from one –

Q Okay.

A From one wholesaler to the other. What the difference in price and whether it's worthwhile to do business with one wholesaler or another. And for the wholesaler, whether they want to offer that price.

Q But whether you are familiar with the specials, and those documents are just not among the ones the lawyers showed you, is that right?

A The lawyers weren't involved at all in this study.

Q No, no, I understand that. But Standard Federal has produced to us in this case documents showing such specials, all right?

In The Matter Of:

GLOVER v.
STANDARD FEDERAL BANK

Jeff Conner
Vol. 1, May 23, 2001 ORIGINAL

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MR. GILL: I've asked an inane question, I'm rising to new heights.

MR. WILSON: Or sinking to new depths, whichever way you want to look at it.

A: It's all a matter of perspective.

Q: Indulge my inanity and answer the question as best as you can, please, Mr. Conner.

A: In a purely hypothetical seat of the pants answer, if the court ruling said that Standard Federal Bank, a federal savings bank, was to no longer pay yield spread premiums I think that Standard Federal Bank, the federal savings bank, could comply with that if that is what the court so ordered.

Q: But the question is, would that order in your judgment control the payment of yield spread premiums by AMRO as the subsidiary of Standard Federal?

MR. STRUBBE: Same objection.

A: Same response —

Q: That isn't a response.

A: — in a totally hypothetical conjecture, that ABN-AMRO Mortgage Group could continue to do business in the current, appropriate manner that it does business today.

Q: So even if Standard Federal were enjoined, you believe AMRO could keep on going?

A: I already answered that.

Q: And the answer was yes?

A: I said that I believe, in this purely hypothetical scenario —

Q: I agree it's hypothetical.

A: — if Standard Federal Bank received an injunction, Standard Federal Bank over here, the FSB, and that's all it said, Standard Federal Bank, FSB, not Standard Federal Bank, FSB and any related venture, subsidiary, but just Standard Federal Bank, FSB was told to stop doing it, it has already stopped doing it. So it would be pretty easy to comply. Part two, ABN-AMRO Mortgage Group in my view could continue to do business as it currently does now in a very appropriate and legal manner.

Q: So in order for the federal court's injunction to stop the entity that's actually paying it today, which is the AMRO Mortgage Group, it would have to extend the injunction so as to cover the subsidiary; is that right?

A: You're making an big leap here.

Q: I think it's a very easy leap. But that's all right, we don't have to argue about the size of the leap.

A: Well, I'm not prepared to make that big of leap. I'm willing to make some conjecture on something, but to now take it a leap, another leap, I don't think —

Q: I don't believe it's another leap. You just think that it would have to specify AMRO Mortgage to make AMRO Mortgage stop; is that right?

MR. WILSON: I have to object to the line of questioning. It is really conjecture and speculative.

MR. STRUBBE: And seeks a legal conclusion.

Q: Mr. Conner, there is a hearing before the United States District Court for the District of Minnesota coming up on the extent to which the court, the relief sought in the Glover case includes AMRO Mortgage as a matter of alignment of parties to the pleadings. So this is a matter that is of direct relevance. And if it is your belief and contention that the court order directed to Standard Federal would not cause AMRO to stop, I'm interested in knowing that.

MR. STRUBBE: I'm going to object. It's a mischaracterization of what's going on in the district court, it's a faulty factual premise, it calls for a legal conclusion. It's a ridiculous question. And I'm sure you'd like to lead off your next brief to the district court with whatever Mr. Conners' answer is however irrelevant. The courts will decide the scope of the order and who it is enforced against.

Q: Of course they will. But I want to know if this is an entity that absent something very specific directed to it will not follow the order of the court directed to Standard Federal Bank.

A: I think you're looking at an issue here that's much bigger than a court order with respect to this industry-wide

practice. And I can't even speculate what the ramifications would be if a court issued that sort of an order. It's beyond what I can speculate.

Q: I didn't ask you about any industry wide, I'm asking about your subsidiary that you are the head of.

A: No. First of all, if a court would issue an injunction specifically regarding that you can no longer pay any form of premium in the course of wholesale lending, this would have ramifications beyond whether ABN-AMRO Mortgage Group felt it had to comply with an injunction to Standard Federal Bank. And I have no way of even giving a wild hair guess on that one.

Q: Okay. That wasn't the question, of course.

A: That's my answer.

Q: That's your speech.

A: That was my answer.

Q: What do you think the purpose of paying the yield spread premiums is that your company pays?

A: Do you really want my view?

Q: Why are you paying them?

A: First of all, I don't — someone came up with this name, yield spread premium. I don't think that's really what it is. We are buying a good from the broker and we are paying a fair market value for that good. It's as simple as that.

Q: I'll accept that as a definition. Did you authorize

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the record of various depositions in discovery responses as being inaccurate.
Q: Thank you. Are you aware that that's the position?
A: I'd have to read it and review it.
Q: Would you think that's an inaccurate position?
A: Once again I'd have to understand exactly the question they were asked and exactly how this conclusion was arrived, at your conclusions as well.
Q: It's not my conclusion.
A: I haven't read it.
Q: So you missed that in Mr. Newman's testimony?
A: I didn't say I read every word or listened to every minute.
Q: I said that you missed that.
A: I probably did.
Q: You missed that in Mr. Capp's testimony?
A: As I said, I didn't read that much of his.
Q: Now, are you aware that your company pays added price inducements to induce brokers in certain geographical areas to refer loans to Standard Federal or AMRO Mortgage?
A: I'm aware of some pricing incentives that we offer from time to time.
Q: Well, that's not an answer to the question.
A: I think it is.
Q: Specifically are you aware that you offer price

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incentives to get the referral of loan business from certain geographical areas?
A: It's built into our pricing so I'm not following you.
Q: Well, that on a particular day your company will add money to the price it will pay for loans in certain geographical areas to get the brokers in those geographical areas to refer the business to Standard Federal instead of to your competitors?
A: I'm not sure it's limited by geography.
Q: Are you aware that that's happened in the past?
A: I said I'm aware that we have pricing incentives. I've said I'm not sure it's limited, I don't get into that much detail. I don't know if the incentives are limited, as you said, to geographical areas. There is other incentives.
Q: There are, and I'm going to come to those.
A: I don't know if geography is the driving force. That part I couldn't answer.
Q: You're not aware of geographical incentives?
A: I'm aware of the incentives.
Q: What incentives are you aware of?
A: That we offer pricing incentives from time to time.
Q: And for what? What extra incentives are you aware that you offer?
A: It's just a pricing incentive. It doesn't mean extra incentive. It's an incentive. It's not an extra incentive,

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it's an incentive.
Q: Well, it is actually an extra above what is being offered for other loans on the same day. That's what I'm talking about an extra incentive.
A: Other loans on the same day?
Q: Yes. You fund loans in Texas on one day and on the same day you fund loans in Minnesota, and you're willing to pay the Texas broker an extra amount of money so that he will send you that business rather than sending it to your competitor but you do not pay the Minnesota broker a similar incentive. Are you aware of that?
MR. STRUBBE: I'll object to the form of the question.
A: If it was that simple, that all we had to do is offer an incentive and the broker would automatically send us his business instead of sending it to a competitor, we could have all of the business in the world and we don't. We have a very small market share. So you're making the implication that we have incentive pricing and that somehow guarantees —
Q: No. I didn't ask that.
A: — that we will get that loan.
Q: No, I never said one word about guarantee. I said the purpose.
A: You said to get the loan from that broker instead of them sending it to the competitor. That's exactly what you

Page 212

said.
Q: I said the purpose of offering the payment is to induce, to try to get him to send it to you instead of to your competitor.
A: The purpose of offering any payment is to induce them to sell it to us. We have to be competitive in the market place. We may offer incentives from time to time, that in no way guarantees we are going to keep this business away from our competitors. It's just a pricing.
Q: Of course. A competitor might offer the broker more money?
A: That's right.
Q: And if so the broker might refer the loan to that competitor and not to you?
A: That's right.
Q: So it's a tough market, where you're offering money to the brokers to try and induce them to send them to you, the competitors are offering money to get them to send it to them, right?
A: Yeah, but I don't understand your geographic.
Q: I'll come back to the geography. Just answer the one question.
A: What I'm saying is we price to get business. And we price what we feel is a market price.
Q: To beat out —

In The Matter Of:

LONNIE AND DAWN GLOVER v.
STANDARD FEDERAL BANK, ET AL.

DAVID PRICHARD
March 11, 1998

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that's true.
BY MR. ROBINOVITCH, CONTINUING:
Q: Okay. So for all — so under these prices everywhere where the price is less than 100 there is no yield spread premium paid?
A: With the exception of adjustments —
Q: Okay.
A: — to the base price.
Q: Forgetting that .25 adjustment, but just on these prices, wherever there's more than 100, that reflects the amount of yield spread premium that's paid to a broker?
A: Yes.
Q: Okay. And at number 100 there is no yield spread premium paid?
A: Correct.
Q: Is 100 the same as what you told me was the par rate when we discussed that earlier? Would that be the par rate?
A: Yes.
Q: Okay. What other factors besides interest rate factor into the amount of yield spread premium that Standard Federal will provide to a broker?
MS. SAVAGE: On what kind of loan,

the Glovers' loan?
MR. ROBINOVITCH: On a 30 — looking at the matrix, we were looking at Program 100 for a 30 year fixed rate loan.
THE WITNESS: Speaking to wholesale strictly, you have the servicing value and InterFirst profit margin in addition to the value of the loan itself.
BY MR. ROBINOVITCH, CONTINUING:
Q: But just looking at these prices right here, is there anything — and I'm referring to Program 100 in the 30 day column — is there anything that factors in to the amount of yield spread premium that Standard Federal is willing to pay a broker as reflected on that column other than interest rate? Is that the only — is interest rate the only factor?
MS. SAVAGE: Asked and answered.
THE WITNESS: No.
BY MR. ROBINOVITCH, CONTINUING:
Q: Okay. Explain that. What are the other factors?
A: In addition to the value of the loan there's the value of the servicing and the required profit margin.

Q: Well, isn't the required profit margin in this price already factored into your price?
A: Yes.
Q: Is not the only factor that affects the amount of money a broker is going to get as a yield spread premium the rate at which he brings the loan to Standard Federal to fund that?
A: No.
Q: What else does the broker do to affect the amount of premium he's going to get?
A: The pricing model doesn't have anything to do with what the broker does or doesn't do.
Q: Mr. Stoller testified that the only variable that determines the yield spread premium he gets or his company gets from this chart is the interest rate. Do you disagree with that?
A: I have no direct knowledge of what Mr. Stoller thinks.
Q: I'm just asking you if you agree or disagree with his statement. The testimony was, "The only variable that determines the yield spread from the chart is the interest rate?" "That's correct, yes." Page 14.
A: Given that that's the only variable in the pricing model that's actually displayed on the

rate sheet, I think that that's a reasonable conclusion on his part.
Q: Are there other variables that the broker has some control over in determining the amount of yield spread the broker company is going to get?
A: No.
Q: Is it not true that the Glovers could have got a lower interest rate on their loan?
MS. SAVAGE: I object to the. . question on the grounds that it's hypothetical in nature. We need clarification as to who.
MR. ROBINOVITCH: I didn't finish.
BY MR. ROBINOVITCH, CONTINUING:
Q: Is it not true that the Glovers could have got a lower interest rate on their loan had there been no yield spread premium paid to the broker?
MS. SAVAGE: Objection, lack of foundation.
THE WITNESS: I don't know.
BY MR. ROBINOVITCH, CONTINUING:
Q: Well, looking at Exhibit 2, Standard Federal would have funded the loan at a rate less than 8.5 percent, would it not?

In The Matter Of:

LONNIE AND DAWN GLOVER v.
STANDARD FEDERAL BANK AND HEARTLAND MORTGAGE

STEVEN C. KAPP
May 19, 1998

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program type.

Q: We'll come back to Exhibit 1. Looking at the 30-year fixed rate program 100 chart or matrix, or whatever you call it. Would you agree that there's a direct relationship between interest rate and the price that Standard Federal would pay a broker?

A: A direct?

Q: Assuming a standard lock period, a 30-day lock, that is the interest rate goes up the price goes up?

A: Yes.

Q: I think I only have one copy. Why is that, as the rate goes up the price that Standard Federal or InterFirst pays a broker or a loss will go out?

MS. SAVAGE: I think that question has been already been asked and answered.

Q: You can answer.

A: I answered. It's a function of the expected cash flows over the life of the loan and how quickly you're going to receive those cash flows.

Q: The profit margin, — let's just take, if you look under, say, the 30-day column. And if we assume that the par price of 100 is somewhere between 8.5 and 8.375 on that day. If you compare the 8

percent, an 8 percent loan and a 9 percent loan on that day would you agree with me that the price that InterFirst is willing to pay a broker is greater on the 9 percent loan?

A: Yes.

Q: Okay. And given that set of circumstances the profit margin on those two loans is going to be stable —

A: Yes.

Q: — to InterFirst or Standard Federal. And the value of the servicing is going to have a negative relationship, is that right?

A: Yes.

Q: Okay. So is there a — is there a positive relationship for the first component, the price that you can sell the loan for?

A: Yes.

Q: To Fannie or Freddie or some other investor?

A: Yes.

Q: Am I correct to assume that the price Standard Federal can sell the loan for exceeds the negative function of the value of the servicing? Do you know what I am trying to say?

MS. SAVAGE: I object to your question on the grounds that it is vague.

MR. ROBINOVITCH: I think so too.

MS. SAVAGE: Take another run at it, please.

Q: The second element, the value of the servicing is a negative factor as you go from 8 percent to 9 percent, right?

MS. SAVAGE: What do you mean by negative factor?

Q: Its affect on price. He told me, I believe, that the value of the servicing decreases as you go from 8 percent to 9 percent. Am I correct?

A: That's correct, depending on the environment of the interest rate environment that you would be at.

Q: So I think all I am trying to establish is that the magnitude of the first component must be greater than the second component for the prices on your sheet to go up?

A: Not necessarily.

Q: Is there ever a time — have you ever seen a rate sheet at InterFirst where as you move — where the prices went to the other direction? You were willing to pay a broker less money for a loan at 9 percent compared to 8 percent?

A: Not that I am aware of.

Q: Why is Standard Federal able to sell the loan at 9 percent at a greater price than the 8 percent loan?

A: I am not sure.

Q: You're not sure of the reason, but you are sure that a 9 percent loan will always sell for a greater price than an 8 percent loan, assuming all other things equal?

A: Not always.

Q: Since you've been at the company, though, you told me you've never seen a rate sheet where you were willing to pay, Standard Federal was willing to pay less money for a lower interest rate loan than a higher interest rate loan?

A: Not since I've been with the company, since I've been group manager.

Q: In your position do you have any contact with individual mortgage brokers or mortgage broker companies?

A: No.

Q: Are the particular services that a mortgage broker performs in any given transaction a factor that go into the pricing on Exhibit 1?

A: No, I am not aware of any services.

Q: How long do you, does InterFirst or Standard

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loans with a larger loan balance create more value?

A: Let's see. How can I do that. The value that we achieve on the loan sale or the servicing value is greater for a larger loan balance because the interest cash flow stream is greater.

Q: When you refer to interest cash flow stream, for instance, you're just referring to a $200,000 loan as opposed to a $50,000 loan results in more interest being paid?

A: Correct.

Q: On a periodic basis. Now, you made some distinction between, from an operational perspective as opposed to some other type of perspective a few minutes ago. Can you clarify that for me? What do you mean by that?

A: From an operational perspective the cost to InterFirst to purchase a hundred thousand dollar loan is the same as it would be to purchase a $200,000 loan. I think I — I think what I did is reversed that. Operationally it makes no difference. Financially the servicing value is greater to InterFirst.

Q: What type of operational perspective were you discussing? What did you mean by an operational

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perspective, the cost to InterFirst is the same. Can you just clarify that?

A: I cannot speak to all the functions that operation goes through when we purchase a loan, but they do the same things for a hundred thousand dollar loan that they would do for a two hundred thousand dollar loan.

Q: Are you referring in terms of having to underwrite the loan and process?

A: Right.

Q: The transaction and do everything on your, on InterFirst's behalf to actually go through with the transaction and process it, that type of thing?

A: Correct.

Q: Okay. Would you also agree that from a mortgage broker's perspective they're looking at their operational, looking at it from an operational perspective, it's the same for them. for a two hundred thousand dollar loan as opposed to a $50,000 loan?

MS. SAVAGE: Objection on the grounds of lack of foundation.

Q: You can answer your understanding, if you know.

A: I can't answer regarding how a broker feels.

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Q: To your knowledge, are there any additional operational type functions that go into the transaction on that perspective?

MS. SAVAGE: Same objection. Lack of foundation. The witness has stated that he can't speak for brokers.

A: I don't know.

Q: Looking at Exhibit 1 again. Over to the left-hand side, the 30-year fixed, Program 100 column and then some of the other charts or matrixes underneath that discussing the prices, right here it says .25 bonus, $100,000 plus. What does that mean?

A: We will add .25 percent to the price if the loan amount is greater than 100,000.

Q: When you say .25 percent is added to the price, that's additional money that goes to the broker?

A: Correct.

Q: So if you have a loan with a principal value of $99,000 and a loan with a principal value of $101,000, and all other — and all other things are the same, the rate, the term, the program and the date, the time they walked in, everything else is the same, the only difference is that the principal value on the $99,000 loan the broker

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receives the price on the chart here, on the matrix part of the chart, these columns; and on the loan with the principal value of a hundred and one the broker would receive the same price on the chart plus an additional bonus of .25 percent?

A: Correct.

Q: And can you explain why that is paid?

A: The cash flow stream on the $101,000 loan is greater than the $99,000 loan.

Q: And that's not paid, so that's not paid based on anything specific, as far as InterFirst notes, that the broker did differently, it's just factored on the principal value?

A: Correct.

Q: That's not tied to any particular service or anything that the broker did?

A: No, not that I am aware.

Q: What other types of bonuses or adjustments to the price that InterFirst will pay a broker on a transaction exists? Are there any others?

A: Are you pluses or minuses or just adds?

Q: Well, let's start with things that increase the price, such as that .25 bonus for loans?

A: Yes.

Q: Over a hundred thousand?

ABN·AMRO ABN AMRO Mortgage Group, Inc.

Statement of ABN AMRO Mortgage Group, Inc.
To The
Senate Committee on Banking, Housing, and Urban Affairs
Hearing of January 8, 2002

The Committee held a hearing on January 8 concerning the payment of yield spread premiums by wholesale mortgage lenders to mortgage brokers. The Committee asked several witnesses to comment on Statement of Policy 2001-1 issued by the Department of Housing and Urban Development on October 18, 2001, and to comment on what HUD should do in an upcoming rulemaking that it announced in the Statement of Policy. ABN AMRO Mortgage Group, Inc. (AAMG)[1] would like to offer the Committee its views on these important issues.

HUD Statement of Policy 2001-1

AAMG strongly supports Statement of Policy 2001-1. We believe the Statement is both a proper interpretation of RESPA and an appropriate clarification of Statement of Policy 1999-1. We believe the courts should give HUD deference for interpreting RESPA as it applies to today's market.

RESPA is a difficult and complex statute that was enacted years before wholesale mortgage lending developed. Wholesale lending has been unquestionably beneficial to consumers, bringing them a wider variety of loan options, lower costs, and the capacity to handle surges in market activity that allow consumers to quickly take

[1] ABN AMRO Mortgage Group, Inc. (AAMG) is a subsidiary of Standard Federal Bank NA. AAMG is the nation's sixth largest mortgage lender, and its wholesale mortgage division, InterFirst Wholesale Lending, is the nation's largest wholesale lender, originating mortgage loans through a nationwide network of over 5,000 mortgage brokers.

advantage of interest rate changes. In developing this market, wholesale lenders such as AAMG have relied on guidance from HUD's regulations and policy statements in developing our wholesale mortgage lending products, practices, and compensation structures. AAMG has been operating in accordance with all of these HUD guidelines.

We believe it is incumbent upon HUD, as the regulator under RESPA, to provide clear and proper interpretation of RESPA at all times, and it is incumbent upon the courts to defer to HUD's interpretation. HUD has the expertise and ability, in its continuing role as regulator of housing finance, to understand the current marketplace and accurately interpret RESPA in the context of the market. This expertise is especially important in the current situation facing the wholesale mortgage industry, where courts disagree and plaintiffs' lawyers venue-shop to find judges who will agree with their views about how the law should apply to the wholesale mortgage market.

HUD has interpreted RESPA in several instances over the years regarding mortgage broker compensation. In 1992, HUD required the disclosure of payments made outside of closing by lenders to mortgage brokers, on both the Good Faith Estimate and the HUD-1 settlement statement. In 1995, HUD issued a letter that described a set of services that could be performed by mortgage brokers, and set forth a policy that a number of these services must be performed by the broker in order to justify compensation by the lender. In 1997, HUD revised the Settlement Costs Booklet that must be provided to all borrowers within three days of application, to include extensive information about what mortgage brokers do, how they are compensated, and what consumers should look for in a broker transaction. In all of these actions, as well as a proposed 1997 rule that was not made final, HUD held that RESPA did not prohibit the payment of yield spread premiums or other forms of compensation to mortgage brokers.

However, despite the efforts of HUD and the compliance of the industry with all of these measures, a massive legal attack has been launched on the mortgage industry over RESPA treatment of mortgage broker compensation. This has led to confusion and uncertainty for nationwide lenders, as courts that are unfamiliar with RESPA come to different conclusions as to its application in today's complex wholesale mortgage market. It is increasingly difficult for lenders to continue operating on a nationwide scale when different courts arrive at different legal standards for our operations.

In 1998, Congress directed HUD to act in this matter and once again clarify RESPA as it applies to wholesale mortgage lending. In the Conference Report accompanying the VA-HUD and Independent Agencies Appropriations Act of 1999,[2] Congress explicitly stated that it was "concerned about the legal uncertainty [regarding indirect compensation to mortgage brokers] that continues absent such a policy statement."[3] Congress further stated that it "never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of Sections 8(a) or (b) of the Real Estate Settlement Procedures Act (12 USC 2601 *et.seq.*)"[4] Congress directed HUD to issue a policy statement clarifying the legality of mortgage broker compensation paid by lenders. Congress further directed HUD to consult with all interested parties in developing this policy statement.

HUD followed the 1998 directive of Congress with the release of Statement of Policy 1999-1[5] on March 1, 1999. The policy statement says that the threshold question is "whether there were goods or facilities actually furnished or services actually performed for the total compensation paid to the mortgage broker."[6] To facilitate the determination of whether sufficient services were performed by brokers to satisfy this initial prerequisite for legality under RESPA Section 8, HUD identifies a typical set of such services and sets out minimal requirements for the number and types of such

[2] H.R. Conf. Rep. No. 105-769, 105th Congress, 2d sess. 260.
[3] Id.
[4] Id.
[5] Federal Register Vol. 64, No. 39, pp. 10080-10087.
[6] 64 Fed. Reg. At 10,085.

services that must be performed.[7] The second—and "determinative"—question under the HUD test is whether the total compensation paid to the broker "is reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed."[8] Under this latter step, "total compensation" encompasses both direct fees (from the borrower) and indirect fees (from the lender), including payments that are based on the "interest rate" of a loan, such as yield spread premiums.[9]

In developing Statement of Policy 1999-1, HUD met with several mortgage industry groups as well as major consumer advocacy organizations. HUD, to its credit, insisted that a consensus of all the participating groups be reached. There was a consensus approval of language establishing the above-mentioned two-part test for determining the legality of a payment by a wholesale lender to a mortgage broker. The policy statement was issued by the Clinton Administration and there was no opposition from the Republican Congress when it was issued.

Statement of Policy 1999-1 did not in any way diminish a consumer's right to seek damages for violations of RESPA, or HUD's ability to enforce RESPA. It also made it clear that yield spread premiums, which, by definition, are a direct mathematical function of the interest rate and dollar amount of the loan, are not *per se* illegal. This was the clear intent of Congress in directing HUD to issue the policy statement. Yet plaintiffs' lawyers and some isolated courts continue to challenge the legality of yield spread premiums based on the definition and method of calculation.

In June 2001, the 11th Circuit Court of Appeals affirmed certification of a class by the U.S. District Court of Alabama in *Culpepper v. Irwin Mortgage Corp.*[10] In its ruling, the 11th Circuit found an "ambiguity" in Statement of Policy 1999-1, and failed to complete its analysis of yield spread premiums by applying an erroneous construction to

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[7] See id.
[8] Id. at 10,085-86.
[9] Id. at 10,084, 10,086.
[10] 253 F.3d 1324 (11th Cir. 2001)

the first step of the HUD test and effectively ignoring the test's second step. The Court also implied that a lower court could, in fact, find that all yield spread premiums are *per* se illegal if they are calculated based on a rate sheet. This decision left the mortgage industry once again facing tremendous uncertainty and the prospect of having to operate under different interpretations of RESPA in different Circuits.

HUD did not agree with the 11th Circuit's view of Statement of Policy 1999-1. HUD has never interpreted RESPA as prohibiting all yield spread premiums, and was rightfully concerned about a court opinion that held that RESPA might be interpreted in this way. HUD exercised its responsibility to remove the "ambiguity" found by the 11th Circuit and clarify the single national standard for determining the legality of mortgage broker compensation, which was its intention in Statement of Policy 1999-1. We agree with HUD that the proper way to do this was through the issuance of another Statement of Policy. In addition to relying on the vast amount of information and opinions received in connection with the 1999 Statement of Policy, HUD once again met with a wide range of interested parties, including industry and consumer advocacy groups, in developing its response. On October 18th, 2001, HUD issued Statement of Policy 2001-1.[11] HUD states in the preamble to this policy statement that:

> This Statement of Policy is being issued to eliminate any ambiguity concerning the Department's position with respect to those lender payments to mortgage brokers characterized as yield spread premiums... In issuing this Statement of Policy, the Department clarifies its interpretation of Section 8 of the Real Estate Settlement Procedures Act (RESPA) in Statement of Policy 1999–1 Regarding Lender Payments to Mortgage Brokers (the 1999 Statement of Policy)....Today's Statement of Policy reiterates the Department's position that yield spread premiums are not *per se* legal or illegal, and clarifies the test for the legality of such payments set forth in HUD's 1999 Statement of Policy. As stated there,

> HUD's position that lender payments to mortgage brokers are not illegal *per se* does not imply, however, that yield spread premiums are legal in individual cases or classes of transactions. The legality of yield spread premiums turns on the application of HUD's test in the 1999 Statement of Policy as clarified today.

Statement of Policy 2001-1 is simply a clarification of existing policy and the existing views of HUD concerning mortgage broker compensation. HUD made clear that the "amount of the [yield spread premium] is not, under the HUD test, scrutinized separately and apart from total broker compensation."[12] Statement of Policy 2001-1 has already been accepted by courts in two rulings in class action lawsuits, *Vargas v. Universal Mortgage Corp.*[13] and *Bjustrom v. Trust One Mortgage Corp.*[14] In *Bjustrom,* U.S. District Judge Marsha J. Pechman of the Western District Court of Washington granted summary judgment to the defendant, Trust One Mortgage Corp. Judge Pechman applied Statement of Policy 2001-1 to find that yield spread premiums are not illegal *per se*. The Court ruled that Statement of Policy 2001-1 is a permissible interpretation of RESPA and therefore must be given deference.

In *Vargas,* Judge James B. Zagel of the U.S. District Court, Northern District of Illinois, denied certification of a class. Judge Zagel agreed with HUD that the fact that yield spread premiums are calculated based on a rate sheet does not make them *per se* illegal referral fees. He also found that there are legitimate reasons why a borrower would choose to pay a higher interest rate on a loan that included a yield spread premium. Importantly, Judge Zagel also found that HUD's two-part test to determine legality of a yield spread premium is faithful to the RESPA statute, and that:

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[11] Fed. Reg. 66, No. 202, pp.53052 –53059.
[12] Id. at 53,053.
[13] No. 01 C 0087, 2001 U.S. Dist. LEXIS 19635 (N.D. Ill. Nov. 29, 2001).
[14] No. C-001166P, 2001 U.S. Dist. LEXIS 17890 (W.D. Wash. Oct 26, 2001.)

> ...the Act [RESPA] compels a case-by-case analysis of individual plaintiffs' claims every bit as much as the HUD Statement. HUD's "reasonableness requirement" was not made out of whole cloth; it is implicit in §2607(c) which authorizes compensation for "services actually performed."[15]

We believe these two decisions indicate that HUD acted properly and correctly in issuing Statement of Policy 2001-1.

AAMG strongly disagrees with some of the views expressed in testimony before the Committee, including certain statements by Professor Howell E. Jackson, one of the plaintiffs' expert witnesses in a class action lawsuit filed against Standard Federal Bank and AAMG. Without attempting to respond to each of Professor Jackson's statements, AAMG attaches hereto the short summary statements of two defense experts in the same case. See Exhibit A, Statement of Professor Roger Bernhardt of Golden Gate University School of Law (concluding that Statement of Policy 2001-1 is entirely compatible with the legislative history of RESPA), and Exhibit B, Statement of Dr. Susan Woodward, former Chief Economist at HUD and SEC (examining the same set of loan data as Professor Jackson, explaining inaccuracies in Professor Jackson's analysis, and discussing a 1989 HUD study regarding the trade-off between a loan's interest rate and the amount of cash the borrowers need up front, and the benefit to consumers of being able to select loans with a yield spread premium).

HUD's Upcoming Rulemaking

AAMG approves of the initiative announced by HUD in Statement of Policy 2001-1, calling for new measures to provide even better information to mortgage borrowers in the application and origination process. It is important to note, though, that current HUD

[15] Id.

rules already require the provision of substantial information to consumers that informs them about mortgage broker compensation and how it is paid:

- Yield spread premiums and other lender compensation to mortgage brokers must be disclosed to borrowers on the Good Faith Estimate of closing costs, which is provided within three days of application.[16]
- Lender compensation to mortgage brokers must also be disclosed at or before closing on the line 800 series of the HUD-1 settlement statement. This disclosure must clearly state that the payment is "paid outside of closing."[17]
- Borrowers also must receive HUD's Settlement Cost Booklet, which clearly states that the "broker may be paid by the lender, you as the borrower, or both;" that there is a correlation between interest rates and points and that "[o]ften you can pay fewer points in exchange for a higher interest rate or more points for a lower rate; that "[s]ome lenders offer 'no cost' or 'no point' loans but normally cover these fees or costs by charging a higher interest rate;" and that "other fees such as those paid by the lender to a mortgage broker or other settlement service providers may be paid after closing/settlement. These fees are usually included in the interest rate or other settlement charge." [18]
- The Settlement Cost Booklet also encourages borrowers to ask questions and to comparison shop.

These current requirements already provide borrowers with useful and important information regarding broker compensation. AAMG fully complies with all these requirements. AAMG agrees with HUD, however, that borrowers could benefit from even better disclosures. For this reason, AAMG currently requires mortgage brokers to

[16] See 24 C.F.R. Part 3500, Appendix B, Illustration 13; Statement of Policy 1999-1, 64 Fed. Reg. at 10087.
[17] See 24 C.F.R. Part 3500, Appendix A, Section L for instructions for completing the HUD-1.

provide borrowers with additional information such as that included in the form loan origination agreement recommended by the National Association of Mortgage Brokers (NAMB) and the Mortgage Bankers Association of America (MBA) and "commend[ed]," but *not* required by HUD[19]. The NAMB/MBA agreement provides:

> The lenders whose loan products we distribute generally provide their loan products to us at a *wholesale* rate. The *retail* price we offer you—your interest rate, total points and fees—*will include our compensation.* In some cases, we may be paid all of our compensation by either you or the lender. Alternatively, we may be paid a portion of our compensation by both you and the lender. For example, . . . if you would rather pay a lower interest rate, you may pay higher up-front points and fees. . . . [I]f you would rather pay less up-front, you may be able to pay *some or all of our compensation indirectly through a higher interest rate, in which case we will be paid directly by the lender. . . .*[20]

AAMG believes it could be helpful for HUD to require that all mortgage originators provide this information to borrowers. AAMG also believes HUD could improve the Good Faith Estimate. Originators should be required to provide within three days of application either:

(a) an enhanced Good Faith Estimate of all settlement costs, with tolerances that could not be exceeded on the HUD-1 settlement statement at or before closing; or

(b) a guaranteed price quote that includes all closing costs and originator compensation, which price could not be exceeded at all.

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[18] 62 Fed. Reg. 31982, 31990 (emphasis added.)
[19] 64 Fed. Reg. at 10087.
[20] See www.namb.org/membership/model_disclosure.htm (emphasis added).

An enhanced Good Faith Estimate with tolerances was a key recommendation of the HUD-Federal Reserve Report to Congress in 1998.

AAMG is pioneering a guaranteed loan price program, which is proving very popular with consumers. Attached as Exhibit C to this statement is a description of the program and from our Website, mortgage.com, that show how the program works for consumers. This program, which is now being offered only through our retail origination channel, offers consumers a guaranteed single price at the time of application, which includes all costs required by us, the interest rate, and discount points. Consumers can review several options for rate and closing costs and choose the one that best suits their financial objectives. They can get a rate and closing cost quote that they can then use to shop among other originators if they choose, before paying any application fees.

Conclusion

AAMG appreciates this opportunity to share its views with the Committee on these important issues. AAMG supports HUD's Statement of Policy 2001-1 as a correct and necessary clarification of RESPA as it applies to mortgage broker compensation. AAMG also supports a HUD regulation that would require improved disclosures and information to consumers. This will help consumers better understand the mortgage process, their options, and how originator compensation works. We believe the proposal we have presented to HUD will accomplish these worthy goals. As the largest wholesale mortgage lender in America, we hope the Committee will consider our views as it reviews HUD's actions and policies on these and other wholesale mortgage lending issues.

Exhibit A

Statement of Professor Roger Bernhardt

Golden Gate University School of Law, San Francisco, California

I understand that this Committee has received testimony to the effect that HUD's 2001 Policy Statement on Yield Spread Premiums is inconsistent with the legislative history of the Real Estate Settlement Procedures Act of 1974 (RESPA). I would like to take this opportunity to correct that misconception.

I am a Professor of Law at Golden Gate University in San Francisco. My field is real property law and real estate finance law in particular. I have written and spoken extensively on these subjects. Having been retained as an expert witness in the action of Glover v Standard Federal Bank, Civil No. 97-2068 (DWF/SRN) (U.S. District Court, District of Minnesota), pending, I undertook an investigation of the legislative history of RESPA, including both the circumstances which led to its original enactment as well as those surrounding its subsequent amendments and regulatory and judicial interpretations. A report prepared by me on this topic and filed with the court conclusively demonstrates that HUD's 2001 Clarification of its earlier Statement of Policy was and is entirely compatible with the consistently expressed intent of Congress.

HUD's 2001 Policy Statement clarifies a two part test regarding the legality of yield spread premium payments made to mortgage brokers: 1) whether the total compensation, including any yield spread premium, was for goods or facilities provided or services performed, and 2) whether the total compensation paid was reasonably related to the value of the total set of goods or facilities actually furnished or services performed.

My Report shows that the original 1972 HUD/VA report to Congress, which preceded the enactment of RESPA, was primarily concerned with kickbacks paid to and by attorneys and title insurers rather than to mortgage loan brokers, because HUD believed that it already had the power to regulate those activities and had always treated loan origination costs as a separate and special issue. Nothing in what HUD declared in 1972 was inconsistent with what it stated in 2001.

My Report shows that at Congressional Hearings, held between 1972 and 1974, the Mortgage Bankers Association in fact supported the prohibition of kickbacks while at the same time recommending that payments made as compensation for loan origination services be expressly validated in order not to appear to violate the new law, and that RESPA thereafter did include such savings language. This record thus supports not only the statutory distinctions between lawful compensation for services actually rendered (e.g., commissions paid to persons who performed the services a branch office would otherwise be required to furnish) and unlawful kickbacks (e.g., referrals paid to a person who did no more than make a telephone call) but also HUD's attempts to distinguish between the two.

My Report further shows that the 1974 Senate Report stressed that the purpose of the new legislation was to eliminate unnecessarily high costs, without prohibiting reasonable payments to persons who actually performed services, and that only amounts in excess of what was reasonable were to be treated as kickbacks. That Report, as well as the language of Section 8(c) itself is entirely consistent with what appears in HUD's 2001 Policy Statement. Indeed, a House Conference Report reasserted in 1998 that Congress never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of subsections (a) or (b) in its enactment of RESPA. Claims that compensation by way of yield spread premium are at odds with legislative history are simply incorrect.

My Report finally shows that HUD's own entire regulatory history, since the first appearance of Regulation X in 1976 and in its published illustrations thereafter, as well as in Congressional testimony in 1998 by its General Counsel and in its Statement of Policy in 1999, has steadily upheld the practice of mortgage broker and loan origination compensation. Thus, it cannot be claimed that the 2001 Clarification was anything more than what it purported to be – a clarification of a long held position; it was neither a deviation from what had been said earlier nor inconsistent with the earlier expressed intent of Congress.

In conclusion, I wish to state that I regard as incorrect and unsupported any claim made to this Committee that yield spread premium payments received by mortgage brokers as part of the total compensation for goods, facilities or services they have actually furnished to their borrowers are improper under RESPA or inconsistent with the legislative history behind that statute.

Exhibit B

Statement of Susan E. Woodward, Ph.D

I am at present Chairman of Sand Hill Econometrics, Inc, Menlo Park, California. I was Deputy Assistant Secretary (Chief Economist) of the Department of Housing and Urban Development from 1987-1992, and Chief Economist, Securities and Exchange Commission, 1992 to 1995. In this statement, I present a short response to Howell Jackson's testimony before this Committee. I have been retained as an expert by defendant in Glover v Standard Federal Bank, Civil No. 97-2068 (DWF/SRN) (U.S. District Court, District of Minnesota), pending, the case in which Professor Jackson has been retained by plaintiffs. We have analyzed the same sample data.

The majority of homeowners today arrange home financing and refinancing through mortgage brokers. Brokers compete with each other in the terms they offer their customers. The terms involve the interest rate on the loan plus cash the borrower pays up front. Each broker—and each retail lender—can offer many different combinations of interest rates and cash.

HUD's 2001 Policy Statement supports consumer choice in selecting among these combinations. It calls for marketplace flexibility with a variety of options for borrowers who have different situations and different needs. HUD recognizes the importance of honest disclosures in helping borrowers make better choices, and in the HUD brochure lenders must give to borrowers, the trade-off between the loan's interest rate and the amount of cash that borrowers need up front is central among the issues HUD urges borrowers to focus on.

The rate-point tradeoff addressed in the Policy Statement has been an issue before. HUD was not, as Professor Jackson claimed, making its policy statement in ignorance of actual rate-point adjustments made by lenders. In 1989, during my watch as chief economist at HUD, Congress inquired as to whether and why the interest rates on smaller FHA loans were higher than the rates on larger FHA loans. We obtained data on FHA mortgage amounts and interest rates and confirmed that the rates were higher on smaller loans. The reason was FHA's cap of one percent on the up-front origination fees paid by the borrower on FHA mortgages. Lenders face many costs that are by their nature fixed amounts and do not rise with the size of the loan. For the smaller loans, one percent of the loan balance does not cover the fixed costs. Lenders must charge a higher interest rate on these loans to cover these costs over time. HUD's economists, who are experts in the interaction of economic forces with mortgage market institutions, recognize this fact.

It should be no surprise that most borrowers select a loan with a yield spread premium. They do so for a fundamental reason—to spread the burden of ownership over time. Closing costs are part of that burden. Mortgage loans are unique among loans in that they *do* break out origination costs separate from the interest rate. By contrast, the practice never occurs with auto loans, home equity loans, or personal signature loans. For these loans, *all* of the origination costs are *always* paid by a yield spread premium, though nobody calls it this. This difference in practice reflects the profound role of the prepayment option in mortgage loan pricing. Origination costs are quoted separately for home mortgages so that borrowers can sort themselves in terms of how long they expect to keep their mortgages. A wide array of choices serves the interests of consumers, as HUD stresses.

Interest rate adjustments are more visible now than ever before due to the wide use of mortgage brokers. In the brokered-loan setting, the *yield spread premium* is cash paid by the lender, calculated based on the size, interest rate, and lock period (and possibly other characteristics) on the loan. A number of plaintiff lawyers and recent witness Professor Howell Jackson claim that mortgage brokers' fees are excessive when part of the broker's compensation is provided by a yield spread premium. Professor Jackson claims that his investigation of broker compensation indicates that the additional, and by his construction "excess", compensation to brokers when a YSP is present is $1,046. I believe that this opinion is based on bad data and an incomplete analysis that fails to consider many important factors that cause variation in broker compensation. His other conclusions are infected by the same problems. I will discuss the problems with the data and then revisit the questions of concern to the Committee.

Inaccuracies in Professor Jackson's data

Professor Jackson's data are pervasively and materially flawed. The data come from two sources: the borrowers' HUD-1 settlement statements, which enumerate the settlement charges and their payees, (collected by hand from these statements by Prof. Jackson and assistants) and from the lenders' electronic records, which contain data on loan amounts, YSPs and buydowns on loans, commitment and funding dates, borrower credit scores, property zip codes, and other loan characteristics. The chief flaw of Professor Jackson's data is that in gathering figures from the HUD-1s to calculate broker compensation, he frequently misses credits from the mortgage broker to the borrower. These credits are more likely on loans with YSPs than those without, and more likely still on loans with large YSPs. The average size of the credits missed by Professor Jackson is nearly $1,000, and seen against average broker compensation of $2,200, this amount is a large, not small, overstatement of broker compensation.

How much more do mortgage brokers earn on loans with a yield spread premium?

With data corrected for the missed credits from broker to home buyer, I find the simple difference in average broker compensation between loans with yield spread premiums and those without premiums is about $550, half of Professor Jackson's estimate. Further, among the loans without a YSP, there are a few loans with zero or very small broker compensation that I suspect to be "friends and family" loans. Eliminating the loans with broker compensation under $250, I find that the difference in average broker fees between those with the YSP and those without it falls to just over $400. As shown below, taking into account factors ignored by Professor Jackson results in an even smaller difference.

Do economic forces explain variation in broker compensation? How does this influence the YSP?

Mortgage brokers earn fees that are subject to market forces. The forces are similar to those that determine the earnings of plumbers and doctors. The earnings of all workers tend to be higher in some areas, such as the big cities of the Northeast. Broker compensation across geographic areas tracks median incomes of those areas closely. Any analysis of broker compensation *must* include these effects, but Professor Jackson omits them.

Another factor that must be considered is the cost of arranging a loan. Borrower credit quality and the loan-to-value ratios affect the level of documentation the broker must prepare to find a willing lender. In addition, when brokers have less time in which to get a loan closed, the fees are higher, as with many other services.

Analysis of the effect of the YSP needs to consider these factors, because they interact with the use of the YSP. Professor Jackson has ignored them. My work has shown total broker compensation, including the YSP, varies with these factors. When I take account of these factors, I find that the total fee earned by a broker for the typical loan is about $300 higher if there is a YSP than if there is not.

I believe that the $300 difference arises from a number of factors. First, there are other determinants of broker earnings that I have not yet been able to measure. Better and more information will likely result in a difference even lower than $300. With each additional variable I have introduced to help explain variation in broker fees, the size of the charge related purely to the presence of a yield spread premium has gone down, not up. Professor Jackson has had the same experience. In his initial work, he omitted an important source of variation in broker compensation, the dollar size of the loan. When he incorporated this factor, the difference in cost associated with the YSP fell.

How much of the YSP is implicitly passed on to consumers?

Professor Jackson's answer is that only 25 percent is passed on. Again, his problem is bad data and incomplete analysis. For the 3000 loans studied, the average YSP is $1,850 and the average difference in broker fees for loans with a YSP is $300 after accounting for other factors. This suggests that borrowers' up front costs are lower by $1,550, or 84 percent of the YSP on average, when a YSP is present.

Do borrowers "need" the yield spread premium?

Professor Jackson suggests that only 25 percent of borrowers are up against lenders' loan-to-value limits and hence cannot borrow more to finance closing costs. Actually, more than one-third of the sample loans have LTVs of more than 80 percent. But to this (more than one-third) we should add another 40 percent of borrowers whose loans are refinancings, not for the purchase of a home. For these borrowers, closing costs are tax-deductible if paid in interest as a yield spread premium, but not if they are paid in cash at settlement. For these borrowers, the yield spread premium route can be advantageous because it makes their closing costs deductible. The borrowers with limited down payments plus those who are refinancing gets us to 73 percent of borrowers, only slightly shy of the 85 percent who select loans with yield spread premiums.

For this remaining 12 percent of borrowers (85-73), and for the refinancing borrowers too, we should ask how long the borrower expects to be in the house. A borrower expecting to stay a long time should consider paying more up front, even paying for a buydown, in exchange for a lower interest rate over the life of the loan.

Those expecting to move soon should be more likely to choose to roll closing costs into the interest rate, because they expect to pay it for a shorter period. How much the yield-spread premium actually costs borrowers very much depends on how long their loans remain outstanding.

Are YSPs a high cost method of financing?

Clearly, if we begin with a figure of $300 or less as the additional broker compensation associated with a YSP rather than the $1,046 that comes from bad data and an incomplete analysis, any reckoning of the YSP-interest trade-off will look better. The other very important factor, ignored by Professor Jackson, is how long the borrower keeps the loan. Home buyers who expect to move again soon will reckon their expected additional interest cost as lower than those who are to be settled for many years. For borrowers in low income tax brackets, the break-even (after taxes) duration of the life of the loan is four to five years. For borrowers in high brackets, the break-even time extends to more than seven years.

Disclosure

Could borrowers benefit from improved disclosure? It is hard to imagine that the HUD-1 settlement statement could not be improved upon. But I will warn the committee that designing a better one is not easy. It must be done with first-rate social science and thorough testing on what helps and does not help people make better choices. Would the presentation of a par option (which may not be an option, and is not synonymous with fair market value in any event) help borrowers? It might, but it might not. I am not even certain that knowing what the broker's compensation is, in addition to interest rates (or monthly payment) and cash to close, is helpful to borrowers. The broker's compensation is certainly not *necessary* information. Perhaps seeing what they regard as a rich deal for a broker provokes borrowers to search further (their best strategy, I think), but maybe not.

All of these are empirical questions. I did no financial disclosure research while I was at HUD, but I did substantial research on financial disclosure while I was at the SEC. I am familiar with the work done by the social psychologists at the FDA on the nutrition label, and regard it as a model of clear and useful disclosure, one which reaffirms the value of standardizing the presentation of information, especially quantitative information. This label was subjected to extensive testing before the final version was adopted. I believe that mortgage loans will be more difficult to illuminate, not less, than food.

Exhibit C

Examples of ABN AMRO Mortgage Group's OneFee Program

(As described on mortgage.com)

Rates and Fees on January 22, 2002

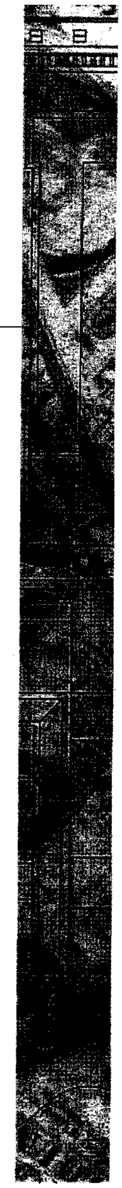
Product	Rate*	APR**	One Fee***
30-Year Fixed	7.250%	7.311%	$371.75
30-Year Fixed	7.125%	7.210%	$682.25
30-Year Fixed	7.375%	7.401%	$(61.63)
15-Year Fixed	6.750%	6.802%	$54.37

*This is the interest rate you would pay if you apply and lock your interest rate and One Fee today online and your loan is disbursed within 60 days from today. Please Note: Your loan must disburse prior to the rate lock expiration date. If you are refinancing, the closing is subject to a full 3 business day right of rescission after the closing date before we can disburse (i.e. we will disburse on the 5th business day after closing.) These rates apply to a loan for an owner occupied, single family detached, primary residence or second home. **The interest rate and One Fee may change daily, without notice. Once you lock, your interest rate and One Fee will be guaranteed for 60 days.**

**The APR's shown are based on a $125,000 loan with a 20% down payment, 15 days prepaid interest and the applicable One Fee for Washtenaw County, Michigan (your fee may vary depending on which state or county your property is located). Prepaid interest can vary depending upon the date of closing. Borrowers may be asked to pay other costs associated with a mortgage application and closing such as odd days interest, private mortgage insurance premiums (if applicable), homeowners insurance, property taxes, intangible taxes, mortgage taxes, and transfer taxes.

***The One Fee includes discount points, lender's title insurance, settlement costs, lender attorney fee (if required), flood certification, tax service fees, and all underwriting, processing, document preparation, closing and funding fees. The One Fee does not include any prepaid interest, intangible taxes, mortgage taxes, or transfer taxes that may be charged by your state, county or city. If the One Fee amount shown above is in parenthesis "()" then it is a negative number and that number designates the amount of cash that will be credited to you at closing.

Wharton



Financial Institutions Center

Another View of Predatory Lending

by
Jack Guttentag

01-23-B

The Wharton School
University of Pennsylvania

The Wharton Financial Institutions Center

The Wharton Financial Institutions Center provides a multi-disciplinary research approach to the problems and opportunities facing the financial services industry in its search for competitive excellence. The Center's research focuses on the issues related to managing risk at the firm level as well as ways to improve productivity and performance.

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Franklin Allen
Co-Director

Richard J. Herring
Co-Director

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Another View of Predatory Lending

Jack Guttentag*

ABSTRACT

Virtually all the analysis of predatory lending in the home loan market has been based on a dual-market paradigm. Sub-prime borrowers, usually less-sophisticated, lower-income, and disproportionately minority, are preyed upon. Other borrowers are not preyed upon, or if they are, it doesn't matter.

The dual-market paradigm has conditioned the remedies proposed for predatory lending. Since sub-prime borrowers can't take care of themselves in the marketplace, government needs to help them by curtailing contractual options, setting price limits, mandating counseling, and the like. These "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help.

This paper presents a single-market paradigm of market failure. It argues that market failure is pervasive, and presents some new data that support this view.

The core reason for market failure is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers. The effective remedy is to make mortgage shopping unnecessary. Eliminating the causes of market failure would eliminate predatory lending.

Mortgage shopping is a highly-skilled professional service that should be purchasable in the market. I call the professionals providing this service "Upfront Mortgage Brokers" (UMBs), to distinguish them from conventional mortgage brokers who contribute to the problem.

UMBs act as agents of the borrower in shopping for a mortgage, are paid a negotiated fee for their services, and disclose and pass through the prices they receive from lenders. In contrast, conventional mortgage brokers are

independent contractors who mark up the prices they receive from lenders, which they do not disclose.

The global remedy to predatory lending is to require by law that all mortgage brokers operate as UMBs. Then borrowers would shop for mortgage brokers, not for mortgages, and need concern themselves only with price, quality and referrals -- the same factors they look at when hiring a house painter or an electrician. Predatory lending would then disappear.

A voluntary association of UMBs, initiated by the writer, already exists. These UMBs are listed on my web site (www.mtgprofessor.com), through which they receive clients. While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation.

**Professor of Finance Emeritus, Wharton. The author is indebted to Richard Herring for helpful comments.*

Another View of Predatory Lending

Jack Guttentag

I Introduction

Virtually all the analysis of predatory lending in the home loan market has been based on a dual-market paradigm. Sub-prime borrowers, usually less-sophisticated, lower-income, and disproportionately minority, are preyed upon. Other borrowers are not preyed upon, or if they are, it doesn't matter.

The dual-market paradigm has conditioned the remedies proposed for predatory lending, which are directed toward practices used abusively in the sub-prime market. Fueled by horror stories and the righteous indignation of community groups, politicians, and regulators, a wave of restrictive legislation and regulations is sweeping the country at the state and municipal levels.

Litan[1] argues persuasively that these "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help, but he and other voices of reason are on the defensive. This is partly because the opposition is supported by mortgage lenders, who are a vested interest perceived as having unclean hands. But it is also because the opposition offers no compelling alternative remedy.

This paper offers a remedy based on a single-market paradigm of market failure. It argues that market failure pervades all sectors -- every borrower is vulnerable. In the prime market the consequences just aren't as obvious and don't cause the same level of distress. And I present some new data that support this view.

The core problem with this market is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers. A few things could be done to make mortgage shopping easier, but it can't be made much easier because it is inherently complex. Few borrowers want to take the time to educate themselves on the complexities. The effective remedy is to make mortgage shopping unnecessary by turning it over to professionals.

[1] See Litan, p. 1.

Mortgage shopping is a highly-skilled professional service that should be purchasable in the market. I call the professionals providing this service "Upfront Mortgage Brokers" (UMBs), to distinguish them from conventional mortgage brokers who are part of the problem.

UMBs act as agents of borrowers in shopping for mortgages, are paid a negotiated fee for their services, and disclose and pass through the prices they receive from lenders. In contrast, conventional mortgage brokers are independent contractors who mark up the prices they receive from lenders, which they do not disclose.

The global remedy to predatory lending is to require by law that all mortgage brokers operate as UMBs. Then borrowers would shop for mortgage brokers, not for mortgages, and need concern themselves only with price, quality and referrals -- the same factors they look at when hiring a house painter or an electrician. Predatory lending would then disappear.

A voluntary association of UMBs, initiated by the writer, already exists. These UMBs are listed on my web site (www.mtgprofessor.com), through which they receive clients. While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation.

Section II of this paper distinguishes predatory lending from market failure. Section III provides some new data that support the thesis of pervasive market failure. Section IV explains market failure in terms of the great difficulty even sophisticated borrowers have in shopping the market effectively. Section V assesses various current or proposed approaches to helping borrowers shop more effectively. Section VI develops the alternative approach of shifting responsibility for shopping to trained specialists – UMBs. Section VII describes my experience with voluntary UMBs.

II <u>Predatory Lending Versus Market Failure</u>

A: Defining Predatory Lending

Predatory lending is a murky concept defined by examples of practices viewed as abusive. Here is a list I developed that is similar to many others.

- **Persuade a borrower to refinance for the sole purpose of generating fees ("loan flipping").**
- **Propose a loan that a borrower cannot possibly repay, that will very likely cause the loss of her home ("equity stripping").**
- **Insert a prepayment penalty or other burdensome provision into the loan contract without the borrower's knowledge, and without their receiving adequate compensation ("contract knavery").**
- **Persuade the borrower to purchase credit insurance or any other third party service of questionable value ("packing").**
- **Charge excess fees or "points" that are not adequately compensated by a reduction in the interest rate ("gouging").**
- **Propose mortgage types that carry high fees, even though they do not meet the borrower's needs as well as alternatives ("steering").**

In its reliance on a "I know it when I see it" kind of test, predatory lending is similar to obscenity. Just as two observers may differ over whether a picture is obscene, they may also differ over whether a particular practice is abusive. And just as there is no end to the sources of obscene expression, there is no end to the list of lending practices that could be used in abusive fashion.

Indeed, the analogy can be pushed further. Whether a particular mode of expression is viewed as obscene often depends on the context. Similarly, as was pointed out in the HUD/Treasury report on predatory lending (p.17), practices that may be abusive in one set of circumstances are not abusive under different circumstances.

To deal with the context problem, those concerned about predatory lending have focused on the sub-prime market – often referred to as the "high-cost" market. Implicitly, it is assumed that abusive practices don't arise in the prime market, or if they do, it doesn't matter.

This dual-market paradigm has conditioned the remedies proposed for predatory lending. Since sub-prime borrowers can't take care of themselves in the marketplace, government needs to help them by curtailing contractual options, setting price limits, mandating counseling, and the like. These "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help.

B. Defining Market Failure

This paper uses a concept more familiar to economists: market failure. In significant numbers of transactions, loan prices are substantially higher than those the borrowers could have obtained on identical transactions had the borrowers been knowledgeable, and able to shop alternative sources effectively.[2]

While predatory lending and market failure have obvious overlaps, there is one area in which they do not overlap. Mortgage pricing based on ability to pay is a clear indication of market failure, but few observers would view it as predatory.

Market failure is a single-market paradigm. It makes no sense that the same market structure would work for some borrowers but not for others. The borrower who pays $10,000 more on a $400,000 loan than he could have paid had he been more alert, astute and aggressive probably won't lose his house as a result, and won't find himself the subject of a news article. Yet he has been hoodwinked just as badly as the borrowers who populate the horror stories appearing in the press.

My point is not to generate sympathy for more well-heeled borrowers but to change the paradigm from which we infer remedies. The single-market paradigm implies that every borrower is vulnerable. The problem is not with the borrowers but with the market, and the remedy is to change the way the market operates. If the causes of market failure can be removed, predatory lending will be eliminated, no matter how it is defined.

III Some Evidence of Market Failure

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[2] Usually, market failure is associated with significant market power or externalities, but neither condition exists in the home loan market.

The evidence I have comes from several mortgage brokers whom I cannot identify. Brokers today touch about 2/3 or more of all home loans. Wholesale Access estimated their market share at 70% in 1998, up from about 20% a decade earlier.[3] The major reason for their growth is the nichification of the market, discussed later.

Mortgage brokers are service providers. They counsel borrowers on any problems involved in qualifying for a loan, help borrowers select the loan that best meet their needs, shop for the best deal among the lenders offering that type of loan, take the application, and lock the terms with the lender at the borrower's request. Brokers also provide borrowers with required disclosures, and compile all the required documents including the credit report, property appraisal, verification of employment and assets, and so on. When the file is complete, it is handed off to the lender, who approves and funds the loan.

Mortgage brokers are paid by borrowers and in many cases, by lenders (see Section IV). The total from both sources is their gross profit from a transaction. The mortgage brokers cooperating with me provided data on gross profits and other transaction characteristics covering 774 loans they brokered in December 2000 and January 2001. The brokers operate in largely upscale areas and all the loans are prime conventional or FHA loans. There are no sub-prime loans in the data set.

If the market for broker services generated the results usually associated with competition, profit per loan would be related to workload per loan. Just as painters charge more to paint a large house than a small one, brokers would charge a higher fee to clients who used more of their time.

Since brokers can't fully anticipate workload in advance, they might elect to ignore it and let workload average out, but in this case there should be little profit dispersion. There should be no relationship between gross profit and loan size, since the number of digits on the loan amount is not related to work load.

What we find is quite different. Table 1 shows a frequency distribution of gross profits on prime conventional loans. The dispersion is very large,

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[3] Wholesale Access, p. 1.

ranging from less than $1,000 to more than $10,000, and there is no relationship to broker workload as measured by processing time.[4]

The major determinant of profit per loan is loan size, as indicated in Table 2, which covers both conventional and FHA loans. For example, borrowers who took conventional loans larger than $225,000 paid almost 4 times as much as borrowers who took loans of $80,000 or less. It is clear that brokers take advantage of the inability of borrowers to shop effectively by extracting more from those who can afford to pay more.

According to the brokers, the other major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer. Table 3 illustrates the force of these factors. It covers the 17 conventional loans in the database that were for exactly $100,000. The profit per loan ranged from $1,077 to $2,748, with no relationship between profit and work load.

[4] According to the brokers, processing time is a fairly good proxy for work-load.

Table 1

Frequency Distribution of Mortgage Broker Profit Per Loan*
(Conventional Prime Loans Only)

Gross Profit Per Loan	Number of Loans	Average Processing Time
Less than $1,000	14	8.8 Days
1,000 to 1,499	56	8.1
1,500 to 1,999	99	12.7
2,000 to 2,499	99	10.3
2,500 to 2,999	84	6.6
3,000 to 3,499	86	8.5
3,500 to 3,999	59	8.9
4,000 to 4,499	51	7.8
4,500 to 4,999	41	8.4
5,000 to 5,999	37	11.4
6,000 to 6,999	20	15.8
7,000 to 7,999	12	5.7
8,000 to 10,000	5	7.6
10,000 and over	4	29.5
Total	667	
Median	$2852	
Mean	$3190	

Table 2

Mortgage Broker Profit Per Loan by Loan Size

	Conventional Prime				FHA			
Loan Size	Number of Loans	Gross Profit	Profit as % of Loan	Ave. Days to Process	Number of Loans	Gross Profit	Profit as % of Loan	Ave. Days to Process
$80,000 and below	95	$1433	2.30	11.68	27	$2188	3.25	22.44
$80,001-$110,000	93	2093	2.17	12.27	45	3234	3.42	21.22
$110,001 - $135,000	108	2420	1.98	7.49	21	3112	2.57	19.17
$135,001 - $165,000	109	2998	2.00	7.29	14	4514	3.01	20.14
$165,001 - $225,000	145	3933	2.02	10.21				
Greater than $225,000	117	5453	1.86	8.86				
Total	667				107			

Loans closed by selected mortgage brokers, December, 2000 and January 2001

Table 3

Mortgage Broker Profit on 17 Loans of $100,000
(Conventional Prime Loans Only)

Profit	Processing Time
$1,077	14 days
1,325	6
1,555	3
1,555	6
1,645	20
1,654	2
1,955	1
2,000	86
2,033	4
2,055	10
2,075	14
2,122	14
2,438	0
2,515	4
2,680	0
2,681	7
2,748	5

Loans closed by selected mortgage brokers, December, 2000 and January 2001

Some economists find it difficult to comprehend how profits per customer can vary so widely in a market with so many lenders and such easy entry. The reason is that borrowers can't shop effectively, for reasons explained below.[5]

IV Why Mortgage Shopping Is So Difficult

The home loan market has unique characteristics that, in combination, create problems for shoppers in all 3 phases of the transaction: Phase 1 when they select a loan provider; phase 2 when the terms of the loan are locked; and phase 3 after the major components of the price are set but the loan has not yet been closed. These characteristics are market nichification, price volatility, rebate pricing, price complexity, locking delays, and processing complexity. They will be discussed in turn.

A. Market Nichification and the Problem of Finding the Applicable Price

Market nichification means that mortgage prices[6] are affected by a wide variety of borrower, property, transaction, and documentation features that affect risk or cost to investors. Prices that are fully adjusted for such features are "transaction specific".

The number of factors used in calculating transaction specific prices keeps growing all the time. For example, when GHR Systems Inc., which develops software that lenders use for pricing, first began operations in the early 90s, lenders recognized up to 4 sets of documentation requirements.[7] Today they use 8. GHR today allows up to 40 million pricing combinations on any single loan program.

Nichification is the major reason for the growing importance of mortgage brokers. The more separate niches the market recognizes in setting prices and underwriting requirements, the smaller the proportion of total niches that

[5] One consequence of the combination of easy entry with barriers to effective shopping is vast excess capacity among loan officers. Many if not most loan officers spend as much as 4/5th of their time looking for customers and only 1/5th dealing with customers.

[6] Unless indicated differently, "mortgage price" will mean a combination of interest rate and points, where points are an upfront charge expressed as a percent of the loan.

[7] The author was a founder of GHR and is currently its chairman.

any one lender covers. This strengthens the position of mortgage brokers who can cover all the niches through their multiple lender relationships.[8]

Prices quoted in the media, on most internet sites and over the telephone are generic rather than transaction specific. Unless informed otherwise, a loan provider generally assumes: [9]

- **The transaction is for a home purchase or a no-cash-out refinance. (2)**
- **The loan is below $275,000 (the current maximum for purchase by Federal secondary market agencies), and above some minimum-- usually around $50,000. (4)**
- **There will not be a second mortgage on the property when the deal closes. (2)**
- **The property is single-family, detached and constructed on site. (6)**
- **The borrower and all co-borrowers intend to occupy the house as their permanent residence. (3)**
- **The credit rating of all co-borrowers is A (good). (4)**
- **The borrower has enough cash to pay the required down payment and settlement costs. (3)**
- **The borrower's income is high enough to meet maximum ratios of housing expense to income and total expense (including monthly payments on existing debt) to income required for the loan program selected. (4)**
- **The borrower can comply with standard (full) documentation requirements. (8)**
- **The borrower is a US citizen or permanent resident alien. (2)**
- **The borrower pays a specified number of points, usually one or two. (10)**

[8] While major lenders expand their product lines to cover new niches, the process takes time and they are always behind the curve. Some niches are so small, furthermore, that it isn't worth the effort of major lenders to accommodate them.
[9] The numbers in parentheses indicate the approximate number of pricing niches that might be recognized for each item.

Nichification causes problems in shopping for a loan provider. Most shoppers don't understand the difference between generic and transaction specific quotes. Shoppers frequently select a loan provider based on generic price quotes, then find that the quotes don't apply to them. Almost all deviations from the list of generic assumptions involve a higher price.

Some shoppers select the loan provider offering the best price, but then change their mind about some feature of the loan: the loan type, down payment, term, documentation, etc. This shifts a shopper into a different pricing niche, where the loan provider already selected does not necessarily offer the best deal. There is very little consistency in pricing across market niches.[10]

If the change of mind occurs after the terms of the loan have been locked, the cost to the borrower can be even greater. The typical applicant knows even less about price differences between market niches than about price changes between two points in time. If the borrower is a home purchaser and the closing date is imminent, the loan provider can pad the price without danger of losing the loan.

B. Market Volatility and the Problem of Obtaining Comparable Price Quotes

Market volatility means that mortgage prices change frequently and without notice. In the 1950s and 60s, mortgage rates lagged changes in bond yields by 3-7 months,[11] but today there is no lag at all. This reflects the extensive development of markets in mortgage-backed securities, which trade as substitutes for bonds. Mortgage lenders reset their prices every morning, and sometime they change them during the day.

Market volatility can nullify the validity of media price quotes used by shoppers. For example, on Monday morning, lenders post their prices for the day, but the price quotes shown in Monday's newspaper were posted the previous Friday.

Because of nichification, obtaining transaction specific quotes usually requires a personal visit to a loan provider. With few exceptions, only

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[10]A few years ago, I looked at 13 lenders and 19 market niches. I found that 11 of the 13 offered the best price in at least one niche but no one lender was best in more than 3 niches. See Jack Guttentag (1996).
[11] Guttentag and Beck, p. 45.

generic quotes are obtainable over the telephone or on the internet. This forces most shoppers to spread their shopping over multiple days. But since prices are reset every day, this is usually fruitless.

C. Rebate Pricing and the Problem of Determining Mortgage Broker Compensation

Rebate pricing means that lenders offer a range of interest rate/point combinations, some of which involve negative points or rebates. (They are also called "yield spread premiums"). The two columns to the left in the table below show an actual price offer schedule for a 30-year fixed-rate mortgage. (For now, ignore the other columns).

Table 4

Rebate Pricing and APRs

Interest Rate	Points/Rebates	Other APR Fees	APR	APR at 5 Years
6.50	3.00 points	1125	6.91	7.52
6.75	1.75 points	1125	6.95	7.46
7.00	0.75 points	1125	7.19	7.46
7.25	0	1125	7.36	7.53
7.50	0.75 rebate	1125	7.54	7.59
7.75	1.50 rebate	1125	7.75	7.66
8.00	2.50 rebate	1125	8.00	7.66

Note: APRs and IRRs assume a $100,000 loan.

Some shoppers monitor the compensation of the mortgage broker. Since prices in the wholesale market are extremely competitive, this strategy makes sense. A competitive wholesale price plus a reasonable fee to the broker should equal a good deal. Most shoppers, however, can't monitor the broker's fee effectively because they don't understand rebate pricing.

The settlement statement given an applicant by a broker at or shortly after the broker has taken an application will show the broker fee to be paid by the borrower. Typically it will not show a rebate paid by the lender, because the rebate will not be known until the final terms are locked. In most cases, therefore, rebates can be pocketed by the broker, unless the broker commits to credit them to the borrower, which very few do.[12] Rebate pricing has been growing in importance, and one of the reasons is that it helps mortgage brokers conceal their profit on a transaction.[13]

D. Price Complexity and the Problem of Comparing Costs Across Products

To this point I have assumed that the "price" of a mortgage consisted of the interest rate plus points. In fact it is more complicated than that. Loans may have origination fees that are expressed as a percent of the loan, and also other upfront charges expressed in dollars. These other charges are usually difficult to obtain until well into the transaction process.

Price complexity is a particular problem on adjustable rate mortgages. The interest rate quoted is the initial rate, which may hold for up to 10 years, but it may also hold for only a month. Where the initial rate holds for a short period, the more relevant rate is the current value of the index to which the ARM rate is tied plus the margin, called the "fully-indexed rate." But that number need not be, and usually is not quoted to shoppers. Neither are borrowers aware of whether rate adjustments are rounded to the nearest 1/8% (or 1/4%), or rounded up.[14]

The Annual Percentage Rate (APR), which is supposed to provide a single measure of credit cost that captures all these components, is defective and unreliable. One problem is that it does not cover all loan fees. Some fees are excluded for no good reason.[15]

A second problem is that the APR is calculated over the term of the loan, even though over 90% of all borrowers sell their house or refinance their mortgage before term. This can lead borrowers with relatively short time horizons astray. The point is illustrated by Table 4, which shows the APRs for the various rate/point combinations, plus what the APR would be if it

[12] The significant exception is Upfront Mortgage Brokers, who do it as a matter of course.
[13] In the Wholesale Access survey referred to above, about 2/5ths of the transactions involved rebates. In my database, covering a period about 2 years later, 3/5ths carried rebates.

were calculated over 5 years. The APR makes it appear that paying 3 points will substantially reduce interest cost, but to a borrower with a time horizon of 5 years, that is not the case.

Calculating the APR over the loan term avoids having to deal with prepayment penalties, which can have a substantial affect on interest cost over shorter horizons.

A third problem is that the APR cannot be less than the interest rate. This means that on rebate loans where the rebate exceeds other APR fees, the APR is deceptively high. This is the case for the 7.75% and 8% loans in Table 4.

A fourth problem is that on refinancing transactions where the borrower withdraws cash ("cash-out"), the APR ignores the loss or gain on the extinguished loan. A borrower raising cash who compares the APR on a cash-out refinance with the APR on a home equity loan can be seriously misled.[16]

In sum, effective shopping requires the ability to compare the costs of different loans over the borrower's expected time horizon. Price complexity makes this difficult, and the APR does not help.

E. Locking Delays and the Problem of Low-Ballers, Market-Price Games, and Phony Locks

Lenders commit themselves to a price when they "lock" the loan. A lock is a written statement that guarantees the rate and points on a loan with specified characteristics to a specific borrower.[17] However, loan providers won't lock when they quote prices to shoppers. In most cases, lenders will lock only after the borrower has submitted an application.

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[14] Rounding up to the nearest 1/8% raises the average rate by up to 0625%, depending on the length of the initial rate period.

[15] For example, fees charged by the lender for property appraisal, credit report, property inspection, loan document preparation, notary, abstract or title search, and mortgage recording are not included in the APR, although none of these fees arises in an all-cash home purchase.

[16] In cash-out refinances, the APR should be calculated on the net cash withdrawn, not on the new loan.

[17] An explicit locking procedure would not be needed if the market was stable, or if lenders were willing to commit to shoppers.

Low-ballers: The combination of locking delays and market volatility provides a cloak for phony price quotes below the market. Some loan providers systematically "low-ball" to get customers in the door. Because a borrower can't shop and lock at the same point in time, the "low-ballers" cannot be held to their price quotes.

Market-Price Games: Sophisticated shoppers understand that the market changes daily, that the price will not be finalized until it locked, and that the lock price is the market price on the lock date. But what very few understand is how the "market price" on the lock date is determined.

For all practical purposes, the market price on the lock date is what the loan provider says it is![18] Loan providers are positioned to exaggerate any rise in interest rates that occurred during the period between the initial quote and the lock date, or minimize any decline. Unlike low-ballers, furthermore, who are well known to (and scorned by) other loan providers, those who play market price games keep their practices under wraps.

Those who low-ball initially to get the customer in the door <u>must</u> cheat in this next phase in order to recover what they previously gave up. Others may cheat a little or a lot, or not at all, depending on their consciences and what they believe they can get away with.[19] In general, they can get away with less in dealing with a refinancer than a home purchaser, because the refinancer can usually bail out and start the process over again with someone else.

The shoppers who are most exposed to market price games are home purchasers who elect to "float" the price until shortly before the closing, usually because they believe that interest rates are going down. A home purchase floater is completely at the mercy of the loan provider, who is restrained only by his conscience and the borrower's ability to pay.

Phony Locks: Borrowers who elect to lock their loans through mortgage brokers are vulnerable to phony locks. The broker reports that the loan is

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[18] I have yet to find a loan provider (other than Upfront Mortgage Brokers) who shares with clients the procedure used for determining the market price on the lock date.

[19] Some loan providers claim that they use their market power to adjust income to workload, which is often far different than they anticipated at the outset. However, the evidence suggests that they are not very successful at this.

locked but in fact does not lock with the lender. The broker elects to arbitrage the difference between the long lock-period price and the very short lock-period price.[20] If interest rates don't change, the broker pockets the price difference.

Brokers rationalize this deceit by claiming that they will stand the loss if interest rates rise. But this ignores the small probability of a price spike so severe that the broker couldn't possibly cover the loss. Then the broker would be off to the Bahamas and the borrower would be left hanging.

F. Process/Document Complexity And the Problem of the Overwhelmed Borrower

Process complexity refers to the many steps, players, and documents that may be involved in a home mortgage loan. For example, the parties may include loan officer, processor, underwriter, appraiser, title insurer, property insurer, credit reporting agency, mortgage insurer, abstract company, pest inspector, flood insurer and many more.

Because there are so many parties involved, lenders won't guarantee total settlement costs other than points until at or near the closing date. The statement of settlement costs that the borrower receives earlier is a "good faith estimate".

This opens the door to chicanery. Some borrowers find that the settlement statements received shortly before closing contain fees that are higher than those that appeared on the Good Faith Estimate of Settlement that they had been given earlier. They are reminded that the earlier figures were estimates and the changes were due to circumstances beyond the control of the loan provider. The borrowers may suspect otherwise, but there is nothing much they can do.

The multiplicity of complex documents creates its own problem. So many documents are required that specialized firms have arisen that do nothing but provide documents. The flood of documents overloads the attention spans of many borrowers, allowing unscrupulous loan providers to take advantage.

[20] For example, lenders might quote 7% and 1 point for a 60-day lock and 7% and ¼ point for a 15-day lock.

For example, I have had dozens of borrowers tell me that they were not aware that they were subject to a prepayment penalty until they went to prepay. How can that be, given that a prepayment penalty must be noted on the Truth in Lending Disclosure Statement (TIL) that every borrower receives?

Anyone who has gone through the process will understand. The TIL is one of a flood of documents that the borrower receives, "Prepayment" is one of many items on the TIL sheet, and the penalty warning is anything but clear.[21]

V Help for the Beleaguered Shopper

I next consider some possible ways the beleaguered shopper might escape the pitfalls described above.

A. "Double-Apping"

Borrowers have one possible remedy available to them now. That is to submit applications to several lenders, and allow the price to float until all of the applications are accepted. Then, on a given day, request the lock price from all of them and select the best.

Few borrowers do this because they don't understand that they can't shop effectively in any other way, and because it is such a lot of work. When it is done, it seldom involves more than two loan providers.

Lenders and mortgage brokers view double-appers as the lowest form of animal life, because receipt of an application initiates a set of costly tasks on their part for which they will not be compensated if they lose the loan. If they discover that it is going on, they may simply terminate their relationship with the borrower.

I don't recommend double-apping to borrowers because it requires deceit, it risks retaliation when discovered, and it is wasteful – the more so the more

[21] The statement says, "If you pay off your loan early, you [may] [will not] have to pay a penalty". The choice between a definite negative and a possible affirmative has got to be confusing. To compound the problem, directly under this choice is a statement regarding whether or not, in the event of prepayment, the borrower will "be entitled to a refund of part of the finance charge". I cannot imagine why this is here, since lenders never refund finance charges.

applications that are involved. It is a sad commentary on this market that better alternatives have been lacking.

B. Development of Internet Delivery Systems

Delivery of home loans over the internet helps with two of the problems that make it so difficult for borrowers to shop the market. The first problem is the difficulty of getting transaction specific price quotes from multiple loan providers on the same day. A number of internet sites today provide price information that is partly but not wholly transaction specific. They adjust prices for some transaction features, although not for all.[22] This makes it possible for some shoppers to acquire transaction specific quotes from multiple loan providers on the same day. Multi-lender web sites make price shopping easier yet.

The second problem is the difficulty faced by borrowers who haven't yet locked their loan in monitoring the market changes used by the loan provider to adjust the price. Loan providers on the internet leave a price trail, making it difficult to cheat. A borrower who delays locking the loan until shortly before closing can't be taken advantage of by a loan provider quoting a spuriously high "market price", because the borrower can check the price against those being quoted to new borrowers. This is very difficult if not impossible to do off the net.

These advantages led to a great deal of early euphoria regarding how the web was going to transform this market, and the writer was one of those caught up in it.[23] In the event, most borrowers turned out to be too fearful of going it alone. While many browse the net for information beforehand, less than 2 out of 100 transact there. Multi-lender web sites in particular are in retreat.[24]

In time, second or third generation mortgage web sites will have figured out how to combine high-tech with high-touch, which will be the secret of success. For now, the web doesn't do it for the vast majority of borrowers.

[22] This is due partly to limitations in their technology, and partly to a reluctance to expand the size of the questionnaire that borrowers must answer. The longer the questionnaire, the fewer the borrowers who complete it.
[23] See Guttentag, 1999.
[24] Two of the four major sites are gone. Quickenloans.com became single-lender, and iown.com folded.

C. Shortening Processing Time

Modern technology makes it possible today to receive a transaction specific price and lock that price on the same day.[25] And it is done, although not often. Note that processing time for 2 of the 17 loans in Table 3 was recorded as zero, which means that the applications were taken and the loans were locked on the same day. This was the case for about 10% of the loans in the database. The other 90% locked days, weeks and sometimes months after the initial contact day.[26]

The 10 borrowers who looked and locked on the same day avoided the market machinations faced by those who select a loan provider but aren't locked. However, they avoided none of the hazards involved in selecting a loan provider, nor were they immune to post-lock hazards.

D. Improved Mandatory Disclosure

In 1998, a joint Federal Reserve and HUD task force developed proposals for improving mandatory disclosures to mortgage borrowers.[27] They would expand coverage of the APR to include all loan charges, and provide more explanatory information. The purpose is to provide shoppers with a better tool for evaluating alternatives.

The report also proposes that lenders be relieved of liability for violations of the Real Estate Settlement Procedures Act (RESPA) if they offer a package of settlement services at a guaranteed total price. The purpose is to avoid situations where borrowers pay higher prices at closing than were shown on the Good Faith Estimate (GFE).

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[25] Smith visits a loan officer (LO) employed by a technologically advanced lender on Monday morning at 11 am. This is just moments after the loan officer had finished downloading new prices for the day. By 1 pm, the LO had entered the financial and property information provided by Smith into its system; had received and incorporated a credit report that Smith had authorized; had discussed with Smith the preferred type of loan, term, down payment and rate/point combination, entering Smith's preferences into the system; and had passed all of this information along to an automated underwriting system, which replied "Approve Smith". Smith completes the 1003 by 2:30, which is transmitted to a "checker" system that, among other things, makes sure that the price for Smith's market niche is correct, and that underwriting rules were applied correctly. Simultaneously, he requests a rate lock. At 3 pm, the lock is approved.

[26] 17% locked in 1-5 days, 18% in 6-19 days, 20% in 20-40 days, and 35%after more than 40 days.

[27] Joint Report (1998).

I support these proposals with a few reservations,[28] but they are essentially a side-show. Provision of an accurate interest cost measure does not help when the price components used in the calculation are vulnerable to change from factors outside of the borrower's control. The proposal for guaranteed settlement costs would shut down a minor abuse, leaving the major ones untouched.

The Joint Report, at various points, recognizes this and tries to deal with it by imposing an additional requirement on lenders: to get the RESPA exemption, they must guarantee not only settlement costs, but the rates and points as well, "subject to prescribed conditions" (P.IV). Elsewhere, they say that changes in rates and points must be "commensurate with changes in the financial markets" (P. XVIII).

But the changes that loan providers make in the rates and points on an unlocked loan are always "commensurate with changes in the financial markets". If you don't believe it, ask them! The devil is in the details of how this is actually done. The Joint Report provides no operational rules that would distinguish justifiable from unjustifiable adjustments to market changes.

E. Anti-Predatory Lending Rules

The legislation and regulations directed to stopping predatory lending that are popping up all over the country rest heavily on the dual-market paradigm.[29] Many focus wholly or largely on what are called "high cost loans", which are defined as loans priced 5-8 percentage points above Treasury securities of comparable maturity. A common provision is mandatory counseling in connection with these loans. This is a clear reflection of the mindset that only one part of the market fails, or only failure in this part matters.

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[28] The proposal to strengthen the APR deals only with the first of the two deficiencies noted earlier. The proposal to encourage lenders to offer a fixed-price bundle of settlement services includes mortgage broker fees in the package of services. Giving lenders the power to set mortgage broker fees is a blockbuster change that could substantially transform the industry, but it is not discussed at all in the Joint Report.

[29] The most comprehensive source of information on legislative and regulatory initiatives is the Predatory Lending Resource Center maintained by the Mortgage Bankers Association (http://www.mbaa.org/resources/predlend/).

A major thrust of these new rules is the elimination of types of loan options that have been used abusively. These include the financing of points, financing of credit insurance, prepayment penalties, negative amortization, and balloon payments. In addition, various abusive behaviors are prohibited, such as making loans that ignore the borrower's ability to pay, or recurring refinancing ("loan flipping").

The problem is that all of these loan options as well as the proscribed behaviors have legitimate purposes. Furthermore, as a HUD/Treasury task force on predatory lending pointed out, "Any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade new government regulation."[30] Furthermore, these rules don't deal with any of the conditions described earlier that underlie the inability of borrowers – all borrowers – to shop effectively.

VI A New Approach to Predatory Lending: Professional Mortgage Shopping

Homeowners who don't have the skill or the time to paint their house hire house painters to do it for them. Mortgage borrowers who don't have the skill or the time to shop effectively, and very few do, should be able to hire an expert to shop for them.

There is a large potential supply of mortgage shopping experts available – they are called mortgage brokers.

Mortgage brokers can shop lenders much more effectively than consumers, because this is what they do. They are in the market every day. Knowledge of market niches is part of their stock in trade. They have relationships with multiple lenders, and are therefore positioned to find and shop among the lenders offering particular features. And they know the lenders who take 10 days to underwrite a loan and those who take one day.

Lenders know that brokers are careful and knowledgeable shoppers while most consumers are not. That's why price differences between lenders are smaller in the wholesale market than in the retail market.

[30] Joint Report, p. 17.

But mortgage brokers now shop for themselves. Acting as independent contractors, they have been a major part of the problem.

The key to effective reform of the home loan market is to mandate that mortgage brokers act as agents of borrowers,[31] and that the fees for their services be explicit. More precisely:

- **Brokers should be required to set their total fee in writing prior to submitting an application to a lender, with acknowledgement by the borrower.**
- **Any compensation received from lenders must be credited against the fee.**
- **Wholesale prices must be passed through to the borrower without markup.**
- **Borrowers must be given written confirmation of price locks from the lender.**

Under these rules, every borrower is a potential monitoring agent, since any disparity between the fee quoted to the borrower at the outset, and the broker compensation revealed in the HUD1 report at closing, would be a prima facie violation of the law.

These rules would protect sophisticated and non-sophisticated borrowers alike, sub-prime as well as prime. Borrowers could still be exploited directly by lenders, of course, but expect that segment of the market to shrink further as borrowers become aware of the new option.

VII <u>My Experience With Upfront Mortgage Brokers (UMBs)</u>

In 1998, I began to write a weekly newspaper column about mortgages, and developed a web site (www.mtgprofessor.com) to contain them. This resulted in extensive contacts with mortgage brokers, from whom I learned the "tricks of the trade" described in this paper. I also learned that most brokers used these tricks within limits. The few involved in predatory practices, however, recognized no limits.

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[31] In a few states including California, it is already the case that mortgage brokers are agents of the borrower de jure. The agency law is without force, however, because it contains no operational criteria for identifying behavior that is consistent and behavior that is inconsistent with an agency relationship. Private litigation hasn't filled this void because mortgage brokers are unattractive targets. Hence, mortgage brokers are independent contractors de facto, regardless of what the law says

I also discovered that there were a few brokers who played no tricks at all; they were completely upfront with their clients. Operating in a market riddled with deception, it cost them clients who couldn't tell the difference, and it cost them fees they could have earned with little effort, but that was the way they wanted to do business. None of them knew each other, and they were delighted to learn, through me, that they were not alone. This was the genesis of UMB.

With the help of several of these brokers, I developed the UMB commitment shown below.[32] For the most part, this commitment merely formalizes and makes explicit what these brokers had been doing all along. UMB is a "best practices" movement.

THE UMB COMMITMENT

"1. The broker will be the customer's representative or agent, and will endeavor to act in the best interests of the customer.

2. The broker will establish a price for services upfront, in writing, based on information provided by the customer.

> ***The price may be a fixed dollar amount, a percent of the loan, an hourly charge for the broker's time, or a combination of these.**
>
> ***The price or prices will cover all the services provided by the broker. This includes loan processing, for which customers always pay a broker or lender.**
>
> ***On third party services, such as an appraisal, ordered by the broker but paid for by the customer, the broker will provide the invoice from the third party service provider at the customer's request. Alternatively, the broker may have the payment made directly by the customer to the third party service provider.**

3. Any payments the broker receives from third parties involved in the transaction will be credited to the customer, unless such payments are included in the broker's fee.

> ***If the broker's fee is 1 point, for example, and the broker collects 1 point from the lender as a " yield spread premium", the broker either charges the customer 1 point and credits the customer with the yield**

[32] I am particularly indebted to Catherine Coy, who works in the Los Angeles area, who has contributed countless hours to my education.

spread premium, or charges the customer nothing and retains the yield spread premium.

4. The broker will use his best efforts to determine the loan type, features, and lender services that best meet the customer's needs, and to find the best wholesale price for that loan.

5. The wholesale prices from which the broker's selection is made will be disclosed at the customer's request.

6. When directed by the customer, the broker will lock the terms (rate, points, and other major features) of the loan, and will provide a copy of the written confirmation of the rate lock as soon as it has been received from the lender.

7. If a customer elects to float the rate/points, the broker will provide the customer the best wholesale float price available to that customer on the day the loan is finally locked.

8. The broker will maintain a web site on which its commitment to its customers is prominently displayed, along with any other information the broker wishes to convey."

To be recognized as a UMB, the broker must have a web site that displays this commitment prominently. The broker's site must also display the UMB logo, and a link to my web site. UMBs are listed on my site by name, URL and the states in which they operate. Thus, potential clients go from my site to their sites, where the client sees the commitment and thus knows what to expect.

While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation. Indeed, the major complaint of UMBs is that they are subject to price competition where other mortgage brokers are not.

VIII Concluding Comment

At this writing, there are 28 UMBs with 43 loan counselors. The movement will shortly be institutionalized by the formation of a non-profit 501(c)3 corporation, with initial support from the Ford Foundation. Support is expected from wholesale lenders, who have a financial stake in the integrity of mortgage brokers. I also expect to see an array of new players enter the market as UMBs.

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Kickbacks or Compensation: The Case of Yield Spread Premiums

by

Howell E. Jackson*[*] and Jeremy Berry[**]

Over the past few years, the federal courts have been inundated with lawsuits challenging the payment of yield spread premiums in residential mortgage originations. The amounts involved are substantial – on the order of hundreds of millions in dollars of payments annually – and as the cases arise under the Real Estate Settlement Procedures Act of 1974 (RESPA or the Act), [1] which provides for treble damages, the stakes are extremely high. Yet within the academic community attention to the controversy has been limited. Most of what has been written on the subject has focused on procedural issues involving class certification. The remaining commentary has explored doctrinal questions regarding the interpretation of section 8 of RESPA,[2] which is the provision

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[*] Finn M.W. Caspersen and Household International Professor of Law, Harvard Law School. This article is substantially similar to an expert report which Professor Jackson prepared on behalf of the plaintiffs in Glover v. Standard Federal Bank, Civil No. 97-2068 (DWF/SRN) (U.S. District Court, District of Minnesota) (submitted July 9, 2001). Professor Jackson's work on this article was supported in part by Harvard Law School and the John M. Olin Center for Law, Economics & Business. David Cope provided extremely helpful consultations on many aspects of our analysis.

[**] Harvard Law School, '03.

[1] Pub. L. No. 93-533, 88 Stat. 1724 (1974).

[2] Section 8 reads as follows:

Prohibition against kickbacks and unearned fees
(a) Business referrals
No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.
(b) Splitting charges
No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.
(c) Fees, salaries, compensation, or other payments
Nothing in this section shall be construed as prohibiting (1) the payment of a fee (A) to attorneys at law for services actually rendered or (B) by a title company to its duly appointed agent

under which the cases are typically brought. Almost no academic writing has seriously grappled with the more fundamental question of whether the behavior at issue in these cases is, in fact, harmful and should be prohibited. This article offers one perspective on these issues.

We begin with a brief explanation of yield spread premiums. Today, one of the principal ways that borrowers obtain home mortgage financing is with the assistance of a mortgage broker. These brokers provide a number of services including helping customers complete loan application forms and providing other services, such as property appraisals and credit reports, necessary to obtain mortgages. In addition and of particular relevance to the debate over yield spread premiums, mortgage brokers typically choose a lending institution to fund the customer's mortgage. Most mortgage brokers have correspondent relations with a number – perhaps twenty – lending institutions. Every day and sometimes even several times in the course of a day, these lenders will supply their mortgage brokers prices at which they are willing to fund mortgages. When the broker is ready to lock in the financing terms for a particular customer, the broker must pick among the terms that correspondent lending institutions offer. Almost invariably, the customer accepts the mortgage broker's recommendation.

> for services actually performed in the issuance of a policy of title insurance or (C) by a lender to its duly appointed agent for services actually performed in the making of a loan, (2) the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed, (3) payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers, (4) affiliated business arrangements . . . or (5) such other payments or classes of payments or other transfers as are specified in regulations prescribed by the Secretary, after consultation with the Attorney General, the Secretary of Veterans Affairs, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Secretary of Agriculture.

12 U.S.C.A. § 2607 (West 2001).

The controversy over yield spread premiums concerns the manner in which mortgage brokers are compensated for their services. One traditional way brokers are compensated is through the direct payments of various fees from their customers. For example, a mortgage broker might receive an origination fee of one percent of the loan amount. In addition, brokers sometimes supplement their income with various other fees, such as document preparation fees, application fees, and processing fees. All of these fees would typically be paid directly by the borrower at or before closing.

Yield spread premiums constitute a separate and less well known way that mortgage brokers are compensated for their services. Yield spread premiums are paid from lending institutions to mortgage brokers. A number of factors influence the setting of yield spread premiums, but the most significant is the rate of interest on the borrower's loan. In the mortgage banking industry, a "par loan" is a loan that a lending institution funds at 100 cents on the dollar. An "above par" loan is one that bears a somewhat higher interest rate and for which lending institutions are willing to pay more than 100 cents on the dollar, for example 102 cents. Typically, the excess over par is paid to mortgage brokers in the form of a yield spread premium. The average amount of yield spread premiums is typically in the range of $1000 to $2000 per loan, and, when present, is usually the largest component of mortgage broker compensation. The more an interest rate charged on an above par loan exceeds the rate for a comparable par loan, the greater the yield spread premium payment to the mortgage broker. Box A on the next page offers a concrete example of these payments.

Box A

Illustration of the Calculation of Yield Spread Premiums

To provide a more concrete example of how yield spread premiums are calculated, consider the following illustration drawn from one of the loan files included in the empirical analysis presented in part three of this article. More complete documentation for this file, in redacted form, is reproduced in Appendix A. These materials illustrate how yield spread premiums are determined.

The yield spread premium for this loan was calculated from the rate sheet of one particular lending institution (InterFirst) in effect at 9:39 AM on September 9, 1998. A copy of this rate sheet appears on the next page. At the time, the borrower in question was seeking a 30-year fixed conventional mortgage for $106,850 with an interest rate of 7.125 percent (This information appears on a rate lock commitment, reproduced in Appendix A, which the lending institution sent to the mortgage broker to confirm the transaction on September 16, 1998.) The loan had a lock term of 30 days, meaning that the proposed rate was available through October 9, 1998. (Again, this information appears on the rate lock commitment.)

Based on the foregoing information, the loan's yield spread premium can be determined by reference to the accompanying rate sheet. Located in the upper right hand corner of the sheet are prices for 30-year fixed conventional mortgages – Program 100. The price for a particular mortgage depends on the interest rate proposed (7.125 percent in this case) and the lock period (30 days). On the accompanying rate sheet, the price for such a loan is 101.625 (circled). This figure means that InterFirst was prepared to pay a premium of 1.625 percent to fund this particular loan. That premium implies a yield spread premium with a base amount of $1,736.13 (or 1.625 percent of $106,850).

To determine net adjustments on this premium, one must read the fine print of the relevant rate sheet. Directly to the left of the prices for Program 100 is a note indicating that InterFirst will pay an additional 0.25 premium for conventional conforming loans in excess of $100,000 (marked with a single star). The loan in question qualifies for this amount because it exceeds the $100,000 threshold. In addition, at the top of this particular rate sheet is a second incentive premium of 0.125 percent for purchase loans (marked with two stars). Again, the loan qualifies because it is for a home purchase, not a refinancing. (This can be determined from the HUD-1 statement included in Appendix A.) Accordingly, the net adjustment on this loan is $ 400.69 (or 0.25 percent of $106,850 plus 0.125 percent of $106,850).

Based on the foregoing analysis, one would predict a total price for this loan to be 102.0, which is in fact the price reported on the rate lock commitment sheet reproduced in Appendix A. In addition, one would predict a total yield spread premium of $ 2,137 (the base amount of $1736.13 plus net adjustments of $404.69). And, in fact, this is the amount of yield spread premium indicated on the third page (line 816) of the HUD-1 statement for this loan.

InterFirst

a division of Standard Federal Bank

CSR Phone Hotline: / Fax Lines: Rate Locks · Conditions · Closings · Funding

DON'T FORGET! .125 BONUS ON ALL PURCHASE LOANS !

FIXED RATES

30 YEAR FIXED - Program 100

(20 year amortization available.) Conventional - Conforming. .25 BONUS $100,000 + (Includes all Community Home Buyers programs) Up to 95% LTV

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

AFFORDABLE GOLD PREMIUM PRICING - Program 100

	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Conforming	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

20 YEAR FIXED - Program 120

Conventional - Conforming. .25 BONUS $100,000 +

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

15 YEAR FIXED - Program 101

Conventional - Conforming. .25 BONUS $100,000 +

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

30 YEAR FIXED JUMBO - Program 102

Conventional - Jumbo. Loan Amounts from $650,000 - $1,000,000 subtract .500

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

15 YEAR FIXED JUMBO - Program 103

Conventional - Jumbo. Loan Amounts from $650,000 - $1,000,000 subtract .500

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

5-25 EXTENDABLE - Program 105

LTVs from 80.01% - 90.00%: Subtract .50 pts from conforming price

FHLMC. Conventional - Conforming

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

7-23 EXTENDABLE - Program 107

FNMA. Conventional - Conforming

Rate	15 Day	30 Day	45 Day	60 Day
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

New Lock Terms for Programs 100,101,102,103,105,107 & 120:
75 Day: (60 Day Price - .125 pts)
90 Day: (60 Day Price - .375 pts)
*120 Day: (60 Day Price - .750 pts) *Not available on program 105

Don't forget! We now accept Investment Property! Eligible for programs 100, 101 & 120 at stated price (-1.5 pts).

--120 Day Extended Lock with Floatdown Option--
Program 100: 7.375 @ 1/4 point fee funded at par; 7.875 @ 1/4 point fee funded at 101.250
Program 101: 7.375 @ 1/4 point fee funded at par; 7.875 @ 1/4 point fee funded at 101.250
Program 120: 7.125 @ 1/4 point fee funded at par; 7.625 @ 1/4 point fee funded at 101.250

--180 Day Extended Lock with Floatdown Option--
Program 100: 7.625 @ 1/4 point fee funded at par; 8.125 @ 1/4 point fee funded at 101.250
Program 101: 7.625 @ 1/4 point fee funded at par; 8.125 @ 1/4 point fee funded at 101.250
Program 120: 7.250 @ 1/4 point fee funded at par; 7.750 @ 1/4 point fee funded at 101.250

--270 Day Extended Lock with Floatdown Option--
Program 100: [illegible] @ 1/2 point fee funded at par; [illegible] @ 1/2 point fee funded at 101.500
Program 101: [illegible] @ 1/2 point fee funded at par; [illegible] @ 1/2 point fee funded at 101.500
Program 120: 7.250 @ 1/2 point fee funded at par; 7.750 @ 1/2 point fee funded at 101.500

* All Extended Lock Fees Are Non-Refundable *

Rate Lock EXPIRATION Schedule

15 Day: [illegible]	60 Day: [illegible]	120 Day: [illegible]
30 Day: [illegible]	75 Day: [illegible]	180 Day: [illegible]
45 Day: [illegible]	90 Day: [illegible]	270 Day: [illegible]

Check out our Jumbo fixed rates!

Our Underwriting Turnaround time is 48 hours!

TEMPORARY BUYDOWNS

Now available for the following Programs: 100, 101, 102, 103, 105, 107, 120, 203 & 225 !

Take corresponding conforming price and subtract percentage shown below!

2/1 Buydown (Programs 100, 102, 103, 105, 107, 203, 225) -2.625 pts
2/1 Buydown (Programs 120) -2.5 pts
2/1 Buydown (Programs 101) -2.125 pts
1/0 Buydown (Programs 100, 101, 102, 103, 105, 107, 120, 203, 225) -.875 pts

EZ MI RATE ADD-ON

LTV	PROGRAMS 100	101	105	107	120
80.01% - 85%	0.375%	0.250%	0.375%	0.375%	0.250%
85.01% - 90%	0.500%	0.375%	0.500%	0.500%	0.375%
90.01% - 95%	0.875%	0.625%	N/A	N/A	0.625%

This program available on all fixed rate conforming and conforming balloon products. (Programs 100, 101, 105, 107, 120)

Rate Sheet No: 2852 - 1 · Page 1 of 2
09:30 AM - WEDNESDAY, SEPTEMBER 9, 1998

Files received today are due out by the close of business on: FRIDAY, SEPTEMBER 11, 1998

NOTICE: Not for distribution to consumers. This information does not satisfy Truth-in-Lending advertising requirements. Rates and prices subject to change without notice. Maximum loan amount is $10,000. (Deduct 1.5 points in price for loans less than $25,000.)

SF 02057

Yield spread premiums are controversial on numerous dimensions. While the existence of these lender payments to mortgage brokers is revealed on government mandated disclosure statements made available to borrowers at closing and sometimes earlier, the form of disclosure is cryptic and does not reveal the relationship between the interest rate charged on the borrower's mortgage and the magnitude of the yield spread premium. In addition to issues of fraud and ethical concerns of such compensation arrangements, the practice raises the unresolved legal question of whether the payments constitute a violation of section 8 of RESPA, which proscribes the payment of kickbacks, referral fees, and unearned payments in connection with real estate settlements. Moreover, there is substantial disagreement about the effect of market forces in this context. A recurring claim of industry representatives is that yield spread premiums do not harm borrowers because market forces demand that compensating reductions be made in other forms of mortgage broker compensation, thus eliminating any additional expense to borrowers. Critics of the practice contest this characterization and argue that yield spread premiums serve principally to enhance the revenues of mortgage brokers and increase the cost of residential mortgage financing.

In this article, we seek to introduce the debate over yield spread premiums to a wider audience. In Part One, we review the legislative background of the Real Estate Settlement Procedures Act, which forms the statutory basis of the yield spread premium litigation. This review illuminates the concerns that motivated Congress to intervene in the area and also provides valuable insight into the kinds of market failures that were widely perceived to exist in the field in the early 1970's. Part One then reviews the actions that federal administrative agencies have so far taken with respect to yield spread premiums and summaries the mounting number of legal decisions address the issue.

In Part Two, we locate the provisions of RESPA in the broader context of financial regulation and argue that the Act's prohibition against kickbacks is characteristic of government interventions in a host of different financial areas. We identify this class of problem as the trilateral dilemma of financial regulation. In brief, this problem arises when a market professional gains de facto control over financial decisions of consumers. In exercising such discretion, the market professional often hires third parties to perform services for which the consumer pays. In such situations, numerous different third party providers may compete among themselves to be chosen to provide these services, and for any particular service provider there will be an incentive to make a side payment to the market professional in order to be selected. Under certain conditions – particularly where consumers are unable to monitor how the market professional selects service providers and are unlikely to police the cost of the provider's services – these practices can become wide-spread and unnecessarily raise costs for some consumers. In addition, the existence of such side payments may permit market professionals to price discriminate among consumers. Part Two concludes with a demonstration of how the practice of paying yield spread premiums shares all of the key ingredients of a trilateral dilemma.

In Part Three we test our theoretical assertions through an empirical investigation of more than two thousand mortgage financings of one affiliated group of lending institutions. The data for this study was obtained through discovery in the case of Glover v. Standard Federal Bank, for which one of the authors is serving as expert witness on behalf of the plaintiff class. In our view, this data offers compelling evidence that for transactions involving yield spread premiums, mortgage brokers received substantially more compensation than they did in transactions without yield spread premiums. Depending on the method of comparison, the estimated difference in costs to borrowers ranges from \$800 to over \$3000 per transaction, and our best guess of the cost impact is approximately \$1046. This difference in mortgage broker compensation and borrower costs is statistically significant at the 99.99% level and robust to a variety of formulations. These findings strongly suggest that yield spread premiums are not a good deal for borrowers, but serve primarily to increase compensation paid to mortgage brokers.

As a separate test of the economic impact of yield spread premiums, we used a series of regression analysis to explore the relationship between yield spread premiums and direct cash payments to mortgage brokers. Industry representatives have argued that yield spread premiums are not harmful to consumers because these payments are recouped through lower direct payments to mortgage brokers. However, our analysis suggests this claims is baseless. With the highest degree of statistical confidence and using multiple formulations, we can reject the notion that consumers fully recoup the cost of yield spread premiums. Our best estimate is the consumers get only twenty-five cents of value for every dollar of yield spread premiums. Seventy-five percent of yield spread premiums serve only to increase payments to mortgage brokers. On average, a very bad deal from consumers.

Our study also provides evidence that the payment of yield spread premiums allows mortgage brokers to engage in price discrimination among borrowers. In transactions where yield spread premiums are not at issue, the vast majority pay mortgage brokers total compensation of not more than 1.5 percent of loan value, and the largest group (on the order of 40 to 45 percent) pay mortgage brokers compensation in the range of 1.0 to 1.5 percent of loan values. In other words, in these markets, there is a pretty clear market price for mortgage broker services. But, when yield spread premiums are present, there is no single market price for mortgage broker services. Most borrowers pay more than 1.5 percent of loan value; more than a third pay more than 2.0 percent of loan value; and roughly ten percent pay more than 3.5 percent of loan value. This price dispersion strongly suggests that yield spread premiums are not simply another form of mortgage broker compensation, but rather that the payments constitute a deceptive device that the mortgage broker industry employs to extract unnecessary and excessive payments from unsuspecting borrowers.

In an effort to corroborate the hypothesis that compensation practices of mortgage brokers disadvantage less well-educated and less financially sophisticated borrowers, we examined the relationship between mortgage broker compensation and the racial identity of borrowers. The results indicated that mortgage brokers charged two racial groups – African-Americans and Hispanics – substantially more for settlement services than other borrowers. For African Americans, the average additional charge was $474 per loan, and for Hispanics, the average additional charge was $580 per loan. While we expect to do more work on this aspect of our analysis, these preliminary results are consistent with our hypothesis that current industry practices allow mortgage brokers to exploit less sophisticated borrowers by imposing higher charges.

Part I: The Legal Context of the Yield Spread Premium Controversy

The controversy over the payment of yield spread premiums can be traced back to the early 1970's when real-estate settlement practices first gained national attention. In this part we begin with a review of the legislative process that lead to the enactment of RESPA in 1974 and the adoption of section 8's prohibition on kickbacks and unearned fees in real estate settlements. We then trace HUD's efforts in the past decade to regulate the payment of yield spread premiums under RESPA. The part concludes with a summary of the wave of recent class action lawsuits that have challenged the payment of yield spread premiums as violations of section 8's prohibitions.

A. The Enactment of RESPA and Section 8's Prohibitions

As described below, the legislative history of RESPA demonstrates that Congress was confronted with substantial and uncontroverted evidence that the settlement of real estate transactions in the United States in the early to mid 1970's was characterized by a number of abusive practices, which appeared to be imposing substantial costs on the American public. Various solutions to the problem of settlement costs were proposed, including direct regulation of settlement costs by the federal government. But in the end, Congress chose to impose a less intrusive solution, relying principally on a combination of mandatory disclosure rules and section 8's prohibition of kickbacks and unearned fees. In this section, we describe how Congress reached this compromise, focusing particular attention on facets of the legislative history that were most closely associated with the Act's inclusion of section 8's anti-kickback rules.

1. The 1972 HUD/VA Report on Mortgage Settlement Costs

Although RESPA was enacted in 1974, the legislative history of the Act dates back several years earlier. In 1970, Congress adopted section 701 of the Emergency Home Finance Act of 1970 in an effort to lower settlement costs in the housing market and assist moderate-income families to purchase homes.[3] Under section 701, which RESPA ultimately superseded, the Department of Housing and Urban Development (HUD or the Department) and the Veterans Administration (VA) were charged with the task of prescribing standards governing the amount of settlement costs on FHA-insured and VA-guaranteed loans.[4] The two agencies were also instructed to undertake a joint study on how best to reduce and standardize settlement costs across the country. That study, completed in March of 1972, greatly influenced congressional actions leading up to the passage of RESPA and affords valuable insight into the contemporaneous thinking about the mortgage settlement business that underlay Congress's decision to enact section 8's prohibition on kickbacks and unearned fees.[5]

One of the 1972 HUD/VA Report's principal findings concerned the payment of referrals and kick-backs in the conveyance (that is, sales) of real estate:

> Competitive forces in the conveyance industry manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions and the like as an inducement to those firms and individuals who direct payment of business. These practices are widely employed, rarely inure to the benefit of the home buyer, and generally increase total settlement costs.[6]

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[3] Pub. L. No. 91-351, § 701 84 Stat. 450, 537-38 (1970).

[4] S. Rep. No. 866, 93rd Cong., 2d Sess. *reprinted in* 1974 U.S. Code Cong. & Admin. News 6546, 6558 [hereinafter 1974 Senate Report].

[5] See Mortgage Settlement Costs: Report of the Department of Housing and Urban Development and Veterans' Administration (Mar. 1972) (Comm. Print of the Senate Committee on Banking, Housing and Urban Affairs, 93rd Cong. 2d Sess.) [hereinafter 1972 HUD/VA Report].

[6] Id. at 3.

The 1972 HUD/VA Report proceeded to explore the "underlying problems" in the mortgage settlement industry, and among other things documented a substantial amount of "economic waste" in the industry. As the following passage illuminates, the report concluded that competition in this sector was not focused on lowering costs for consumers but rather on benefitting commercial concerns in the position to refer lucrative opportunities to those in the business of offering settlement services:

> In most cases, competition in the conveyancing industry is directed toward other participants in the industry, and not toward the home buying public. Lenders compete to get business from realtors or escrow companies. Title companies compete to get business from attorneys, brokers, or lenders, and so on.
>
> The buyer seldom decides who will provide settlement service for him. If there is a choice, he will usually depend on the advice of this broker, escrow agent, or settlement attorney.
>
> The competition that exists in this industry, therefore, is not based on price, because the ultimate consumer has a small voice in that decision. Although the industry is very competitive in many areas, the competitive forces that do exist manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions and the like. These practices are widely employed and have replaced effective price competition.
>
> These referrals or kickbacks paid by or to lawyers, lenders, title insurance companies, real estate brokers and others result in unnecessarily high costs. Referral fees, kickbacks, or other similar arrangements explain, in part, why fees for conveyancing services often do not relate to work performed. Information obtained from this study indicates that referral practices are widespread. The system of referral fees has become so entrenched; and frequently, little is done to hide the fact that these fees are paid. . . . [7]

This passage offers a picture of the problem of real estate settlement, as presented to Congress in the early 1970's. According to the report, borrowers either did not participate in the selection of providers of settlement services or were dependent on the advice of a broker or other professionals. Given this power to "direct the placement of business," these professionals routinely extracted kick-

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[7] Id. at 15-16.

backs and referral fees, thereby increasing total settlement costs.[8] According to the report, the practice of extracting kickbacks and referral fees was so widespread in the industry that little attempt was made to hide the practice. That is, general knowledge that such payments were being made was not, apparently, sufficient to eliminate the practice or to permit borrowers to recoup the cost of kickbacks and referral fees through an off-setting reduction in other expenses.

Another element of the 1972 HUD/VA Report's findings concerned the manner in which settlement charges were calculated: "Settlement charges often are based on factors unrelated to the cost of providing the services. The overall level of charges tends to be significantly lower when the charge for a service is not directly related to the sales price of the property."[9] The Report later elaborated:

> [T]he fees for many services are charged on the basis of sales prices. This is seldom justifiable. There is no implicit reason for undiscovered title defects to increase with the sales price; yet the fee for title insurance does. Neither is there any reason for a broker's job to necessarily be more difficult on a more expensive home. These fees are the result of tradition and not the result of economics."[10]

The implication of this aspect of the Report is that settlement costs would have been lower if fees were not calculated in a manner that bore so little relationship to the costs of providing the services in question.

The 1972 HUD/VA Report concluded that practices in the mortgage industry were so

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8 Id. at 2-3.

9 Id. at 3.

10 Id. at 33.

problematic that the federal government should establish maximum allowable settlement costs.[11] This proposal to regulate rates was highly controversial, and the ensuing congressional debate leading up to the enactment of RESPA two years later was largely cast in terms of a choice of whether to adopt the 1972 HUD/VA Report's draconian rate regulation proposal or some more modest form of governmental intervention.

2. Contemporaneous Press Accounts

Another important influence underlying the passage of RESPA were contemporaneous press accounts documenting abuses in the real estate settlement practices. Particularly noteworthy were a series of press accounts in the *Washington Post* early in 1972, just before the 1972 HUD/VA Report was released. These articles were introduced at hearings of the subcommittee on Housing of the House Committee on Banking and Currency,[12] and also cited in congressional reports accompanying the Act as ultimately passed.[13] To begin with, the *Washington Post* stories confirmed the existence of market failures of the sort identified in the 1972 HUD/VA Report. According to the

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[11] Id. at 69-70. In addition to this regulation of rates, HUD also proposed to adopt regulations prohibiting the payment of kickbacks in connection with HUD-insured loans: "The proposed regulation is aimed at prohibiting the payment by the mortgagee of fees to realtors and others who refer or place the loan with the lender. . . . The buyer or seller indirectly pays such fees when they are included." Id. at 71.

[12] See Real Estate Settlement Costs: FHA Mortgage Foreclosures, Housing Abandonment, and Site Selection Policies: Hearings Before the Subcomm. on Housing of the House Comm. On Banking and Currency 1 (1972) [hereinafter 1972 House Housing Hearings] (the articles were introduced into the record by Subcommittee Chair Rep. William A. Barrett).

[13] See, e.g., 1974 Senate Report, *supra* note 4, at 6558 (additional views of Senator Proximire).

Washington Post, settlement costs were a "mystery to most home buyers."[14] There was, moreover, evidence that this ignorance on the part of consumers allowed for substantial variation in settlement costs in different regions of the country, with home buyers in the Washington, D.C., area paying two to three times more than comparable buyers in, for example, Boston.[15] A commonly advanced explanation for this variation in fees was the prevalence of kickbacks and other hidden payments in certain parts of the country. While contemporaneous press accounts revealed that kickbacks were paid in many different contexts, an illustrative example concerned payments made from title companies to settlement attorneys. The *Washington Post* explained the practice in the following terms:

> The most common arrangements in the Washington area were found to be kickbacks and other hidden payments given by lawyers and by title insurance companies. . . .
>
> Although some lawyers, title insurance companies, lenders, developers, builders, and brokers will have no part of the deals, many of the practices are so pervasive that it is difficult to find exceptions.
>
> What such kickbacks amount to, says Seymour Glanzer, chief of the U.S. attorney's fraud unit, is "commercial bribery" that directly inflates settlement costs paid by home buyers.
>
> The purpose of giving kickbacks and hidden payments is to gain referral of home buyers' settlement business, and the referral methods are not always subtle.
>
> . . . .
>
> Almost without exception, Maryland lawyers pocket a quarter to a third of the title insurance premium that home buyers with mortgages are required to pay. This is their commission for choosing a particular insuring company and accounts for 27 per cent of premiums paid by home buyers to Washington's four major title insurance companies.
>
> Although they are legal, the commissions, according to bar association

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14 1972 House Housing Hearings, *supra* note 12, at 2.

15 See id. In the 1972 HUD/VA Report, government investigators also documented substantial regional variations in settlement costs. See 1972 HUD/VA Report, *supra* note 5, at 2. 32-33.

> officials, would violate bar ethics unless lawyers obtain buyers' permission to take them. However, buyers are seldom consulted.[16]

A noteworthy aspect of the *Washington Post* series was the assertion that the payment of kickbacks and unearned referral fees was widespread in certain markets notwithstanding the fact that the practice was in violation of legal norms, in particular standards of professional responsibility. Similar assessments appeared throughout the hearings leading up to the enactment of RESPA.[17]

3. Perspectives from Congressional Hearings

Against the background of the 1972 HUD/VA Report and the mounting press coverage of mortgage settlement practices, Congress held a series of hearings between 1972 and 1974.[18] A variety of views were expressed, but a common opinion was that, while rate regulation of the sort advanced in the 1972 HUD/VA Report would be cumbersome and potentially counter-productive, some federal action was needed, particularly to enhance the level of consumer understanding of settlement costs and to alleviate the problems of kickbacks and referral fees. Illustrative of this sentiment was testimony of Representative Robert G. Stevens, Jr., sponsor of one of the bills that eventually formed the basis of RESPA:

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[16] See id.

[17] Consider, for example, the following testimony of Thomas R. Bomar, Chairman of the Federal Home Loan Bank Board:

> [Referral payments for settlement services] violate anti-kickback statutes. In addition, they are violative of the canons of ethics of the legal and real estate professions. Moreover . . . such actions may well violate existing federal criminal law dealing with commercial bribery . . ."

Real Estate Settlement Costs: Hearings Before the Subcomm. On Housing of the House Comm. on Banking and Currency, 93rd Cong. 2d. Sess. 56 (1974) [hereinafter 1974 House Hearings]. See also 1972 House Hearings, *supra* note 12, at 1-19.

[18] See sources cited *supra* notes 12 & 17.

> The proponents of federal rate fixing have said that the establishment of maximum charges is needed because of the abuses that exist in the settlement process. I find this line of argument to be totally without merit. If there are abuses, let us correct them; if there are particular problems that give rise to unnecessarily high settlement costs, let us deal with them. The imposition of federal rate regulation on so many businessmen and attorneys cannot be justified when the *underlying problems and abuses* can be dealt with directly by the Congress.[19]

Throughout the hearings, Congress was repeatedly urged to eschew price controls for settlement costs in favor of more targeted regulation aimed at specific abuses.[20]

One of the most frequently cited abuses was the practice of granting kickbacks and referral fees. Witnesses from disparate corners of the real estate industry concurred that kickbacks and referrals in real estate settlements should be outlawed. The following excerpts suggest the tenor of the debate on this point:

> "A final provision which we feel to be vital to any legislative package on settlement costs would be a prohibition on kickbacks and unearned fees." [21]
>
> * * * *
>
> "In your kickbacks, I am rather shocked at the things that occurred that brought this to public light, and I had no notion they went on."[22]
>
> * * * *
>
> "In the [Montgomery County (Md.)

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19 1974 House Hearings, *supra* note 17, at 50 (emphasis in original).

20 See, e.g., id. at 305 (testimony of H. Harland Crowell, Jr., National Association of Realtors) ("In this country, we believe that a free market, functioning correctly, is the most efficient and equitable way of allocating goods and services. If the market breaks down, we should try to determine the specific failing and correct it so that the simplicity and essential fairness of the market system can be preserved.").

21 Id. at 61 (testimony of Sheldon B. Lubar, Ass't HUD Secretary for Housing Production and Mortgage Credit).

22 Id. at 107 (testimony of William P. Dickinson, Chairman, ABA Special Committee on Residential Real Estate Transactions).

Mortgage Broker Fee Agreement

In the following: "I" or "me" = applicant; "You" = mortgage broker

Mortgage Broker Service. You are duly authorized and prepared to assist me in arranging mortgage financing for my home, and you agree to provide such assistance, as set forth below.

Amount of Broker Compensation. I understand that, as compensation for the goods, services and facilities you provide, your total mortgage broker compensation from all sources will not exceed:

[$_______________]

and / or [*specify which*]

[_______________ point(s)] (one point equals 1 percent of the original principal balance of the actual mortgage loan obtained).

Method of Broker Compensation Payment. I understand that I may have a choice as to how your compensation is paid. Depending on such factors as my financial circumstances, whether I qualify for a loan and/or whether a loan program is available:

- I may pay your compensation for the services you provide out of my pocket directly.
- If I want to lower the amount I compensate you out of my pocket directly:

  → I may have the lender pay some or all of your compensation, in which case the lender will charge me a higher interest rate which could result in higher monthly payments; and/or

  → I may use the proceeds of the loan to pay some or all of your compensation, in which case I will be obligated to repay that amount with interest over the term of the loan.

I understand that I should discuss with you in further detail the specific options available to me to pay for your compensation, including the impact of each such option on the amount of cash I must bring to the closing, my interest rate, loan amount and monthly payments.

Nature of the Relationship. [Choose appropriate text][standard][I understand that in connection with this Agreement, you are not acting as my agent. You are also not acting as the lender's agent. Although you seek to assist me in meeting my financial needs, you may not make available the products of all lenders or investors in the market or the lowest prices or best terms available in the market.]

[California/FHA][I understand that in connection with this Agreement and any mortgage loan you arrange for me, you are acting as my agent. You are not acting as the lender's agent. Although you seek to assist me in meeting my financial needs, you do not distribute the products of all lenders or investors in the market and cannot guarantee the lowest price or best terms available in the market.]

[lender's agent] In assisting to arrange financing for my home, I understand that you are not my agent and that you are acting as the agent of the lender.]

Termination. This Agreement will continue until one of the following events occurs:

- I fail to receive loan approval;
- My loan closes;
- I terminate this Agreement;
- You and I enter into a new Mortgage Broker Fee Agreement; or
- ___________ days expire from the date of this Agreement without any of the foregoing occurring.

Mortgage Broker Fee and Disclosure Acknowledgement

By signing below, I/we understand and agree to the terms of this Agreement. The contractual obligation to comply with this Agreement rests solely with the mortgage broker and the applicants signing below. No other entity shall be liable for any misrepresentation or non-performance of the mortgage broker's obligations under this Agreement, or the mortgage broker's collection of compensation in excess of the maximum compensation amount stated herein.

Signing this Agreement does not obligate me to obtain a mortgage loan through you, nor does it prevent me from shopping for mortgage loans with any other mortgage broker or lender. This Agreement does not constitute a loan commitment or otherwise indicate mortgage loan approval.

I acknowledge that you and any lender that makes a loan to me is relying upon this Agreement and upon my statement that I actually understand your role in the transaction and how you will be paid.

* * Applicant____________________ Date_______________

* * Applicant____________________ Date_______________

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Mortgage Broker's Signature
Mortgage Broker's License No. (where applicable) ____________________

National Association of Mortgage Brokers

Key Facts About NAMB and the Mortgage Brokerage Industry

The National Association of Mortgage Brokers (NAMB) is the only national trade association exclusively representing the mortgage brokerage industry. With 39 state affiliates and 14,000 members, NAMB promotes the industry through programs and services such as education, professional certification, and government affairs representation. NAMB members subscribe to a code of ethics that fosters integrity, professionalism, and confidentiality.

What is a mortgage broker?

A mortgage broker is an independent real estate financing professional who specializes in the organization of residential and/or commercial mortgages. A mortgage broker is also an independent contractor who markets and originates loans offered by multiple wholesale lenders.

- A mortgage broker provides the consumer an* expert mentor through the complex mortgage origination process. Mortgage brokers have helped many low to moderate income borrowers, with less than perfect credit histories, enjoy the benefits of homeownership.

- By offering superior market expertise and direct access to many different loan programs, a mortgage broker provides the consumer the most efficient and cost-effective method of obtaining a mortgage that fits the consumer's financial goals and circumstances.

- There are over 20,000 mortgage brokerage operations across the nation that originate over 60 percent of all residential loans in the United States. These firms employ an estimated 200,000 people.

- The mortgage brokerage industry plays a significant role in the mortgage lending process and the American economy by increasing competition and driving down costs. Mortgage brokers originate more mortgages than any other single loan source.

* According to the Random House College Dictionary, mentor means, "a wise and trusted counselor." Banking Housing and Urban Affairs Staff

NAMB
National Association of Mortgage Brokers

NAMB FACTS

- The National Association of Mortgage Brokers (NAMB) exists to serve the needs of the professional mortgage broker. Its mission is to be an advocate for mortgage brokers, to provide services in the areas of education, meetings, and legislation, and to lead its members in promoting professionalism and integrity.

- NAMB has over 5,000 members, including residential and commercial brokers who originate mortgages and work with a variety of lenders. We are a growing, dynamic, and energetic group of civic-minded mortgage industry professionals.

- Mortgage brokers are estimated to originate over one-half of all residential mortgages in the nation.

- NAMB supports a public education campaign to encourage homebuyers to "see a mortgage broker first." Using a mortgage broker is the best way to secure the best mortgage rates and terms available. In addition, NAMB members educate homebuyers about the mortgage lending process. Mortgage brokers have an in-depth understanding of-- and a daily exposure to-- the problems and challenges of real estate financing.

- NAMB encourages its members to foster a fair lending environment that promotes affordable housing and eliminates lending discrimination. NAMB will make every effort to participate with HUD, Fannie Mae, Freddie Mac, and other federal and state agencies in any event or program that addresses these issues.

- NAMB presently has 38 state affiliate chapters, with more under development.

- NAMB staff work with regulators and legislators on mortgage finance issues; track legislative and regulatory initiatives to ensure that NAMB positions are presented to key decision-makers, and; coordinate activities with industry and consumer groups to present more efficient products to the homebuying public. NAMB staff also administers NAMB's education, professional certification and member benefits programs.

- NAMB publishes *National Mortgage Broker*, the only national monthly magazine devoted exclusively to mortgage brokers, with a nationwide circulation of approximately 6,500.

- NAMB provides members with a collective voice on issues and offers services normally available only to larger firms. Most mortgage brokerage firms are small, entrepreneurial businesses, with an average of 6-10 employees.

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January 23, 2002

The Honorable Paul S. Sarbanes, Chairman
United States Senate
Committee on Banking, Housing and Urban Affairs
534 Dirksen Building
Washington, DC 20510-6075

Dear Senator Sarbanes:

I have recently had the opportunity to review the transcript of Rita Herrod's testimony before your committee on January 8, 2002 regarding *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premium*. I reviewed the transcript and I believe it to be an accurate record of what was said. However, Ms. Herrod and I noticed there was an exchange between you and her that, while technically correct, may be misleading.

On pages 32-33 of the unofficial transcript the following exchange took place:

The Chairman. Now, Ms. Herrod, you had a variable rate loan which started at 7.8 percent. Correct? In the beginning.

Ms. Herrod. In the beginning.

The Chairman. Yes. And you wanted to refinance, hopefully to bring down your payments. And also, you wanted to consolidate some debts to pay them off.

Ms. Herrod. Yes.

The Chairman. But the loan that Mr. Young, your broker, got – I'm not sure I should call him your broker. The loan that Mr. Young, the broker, got for you was close to ten percent.

Is that right?

Ms. Herrod. Right. I think it was nine, maybe nine point something.

The Chairman. Yes. Did you understand prior to the closing that your interest rate was going to be so much higher than the loan you already had?

Ms. Herrod. No.

Ms. Herrod's responses to your questions in this exchange are correct, but it seems to me that there exists a slight misunderstanding. Ms. Herrod had another loan in between the 7.8% loan and the loan Mr. Young arranged. The interest rate on that loan was around 9% when she refinanced with First Security. The loan Mr. Young arranged was indeed higher than her prior loan, and she did not realize that would be the case, but the existing loan at the time was not the 7.8% interest rate loan.

I do not think this misunderstanding is material to the substance of Ms. Herrod's testimony, particularly how it relates to yield spread premiums. But both Ms. Herrrod and I thought the issue should be perfectly clear, and that no misunderstanding, no matter how insignificant, should persist.

On Ms. Herrod's behalf, let me thank you once again for allowing her to tell her story at the hearing. It is our hope that her testimony will contribute to some sort of reform that prevents future abuses like what happened to Ms. Herrod and her daughter. I would like to thank you personally for your continuing support of consumer issues in the Senate. Additionally, it is certainly refreshing to have a frequent advocate for consumers in Washington.

If you have any questions or concerns, or if I can be of further service to you in any way, please contact me.

Sincerely,

Bren J. Pomponio

Bren J. Pomponio

cc: Rita Herrod

No Shades of Gray – HUD's *New* Statement of Policy Hurts Homeowners and Will Cost Millions

Consumer Analysis[1] of HUD's 2001 Policy Statement on Lender Payments to Mortgage Brokers

Despite HUD and the mortgage industry's claims to the contrary, there should be no doubt that HUD's Statement of Policy on Lender Payments to Mortgage Brokers, issued October 15, 2001, will have one result – homeowners will continue to pay thousands of dollars in extra interest expense as a result of illegal lender paid broker fees.

The unambiguous intent of HUD's new Statement of Policy was to shield the industry from class action law suits challenging the legality of these fees. HUD attempted to mitigate this anti-consumer action by proclaiming that a "new" rule would require that additional information provided to consumers would change the predatory practices of some brokers and actually provide protection to consumers. However, the new disclosure recommended by HUD is not new – it was specifically recommended by HUD in the 1999 Statement of Policy. If the industry had wanted to comply with RESPA's requirements and avoid liability, the industry could have adopted the practices HUD recommended two years ago.

More importantly, if HUD's action of October 15, 2001 withstands judicial scrutiny, it will have the effect of insulating the mortgage industry from all liability. If consumers have no effective way of enforcing a rule, than the rule provides consumers with no protection. HUD stated repeatedly in the 2001 Statement of Policy that each case must be individually reviewed to determine compliance. The intent and effect of requiring individual case analysis is to prohibit class actions. Unfortunately, without class actions, there will be no effective enforcement of any consumer protection under RESPA – the few individual actions brought will not provide any incentive to the industry to comply with the law. Proof of this is found in the fact that the industry continued to balk at compliance with the rules recommended in the 1999 Statement of Policy, because the industry believed at that time that they were immune for class action liability.

Consumers' Position

For many years attorneys and advocates for consumers have been challenging the insidious use of lender paid broker fees. Lender paid broker fees can have the relatively modest effect of increasing the interest rate of a loan by one eighth or one quarter of one percent, which still will cost the homeowner thousands of dollars in excess interest over the course of the loan. On the other hand, lender paid broker fees are often a major component of predatory lending – providing the incentive to brokers to refinance loans, and justifying the use of onerous prepayment penalties.[2]

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[1]This analysis was written by Margot Saunders, National Consumer Law Center.

[2]The line between these types of cases is often blurred. Consider the facts of one of the named plaintiffs in the case of *Culpepper v. Irwin Mortgage Corp.*, 253 F. 3d 1324 (11th Cir. 2001). Beatrice Hiers

Consumers who do business with mortgage brokers generally have the understanding that the brokers will provide them the loan at the lowest rate which the broker finds for them. Consumers have generally understood and agreed to a specific broker's fee to be paid directly by them – either in cash or by borrowing more – to the mortgage broker to compensate the broker for obtaining the loan. What consumers do *not* understand, and have not agreed to, is when the mortgage broker receives an *additional* fee from the lender. These fees are generally paid by the lender to the broker *solely in compensation for the higher rate loan.* In other words, the lender would have made the consumer a loan at a lower rate, but because the loan is provided at a higher rate, the broker is paid a fee, or kickback. These fees are solely an extra fee the broker is able to extract from the deal. The result is the borrower will have a higher interest rate for the life of the loan.

Not all lender paid broker fees are bad or illegal. We agree with the oft-stated premise in HUD's and the industry's pronouncements that when the lender paid fee is used to reduce the closing fees owed by the borrower, borrowers can benefit from the payment of these fees. However, these are not the types of loans which are the subject of either the class actions, or our concerns. We are concerned with the cases where the homeowners' fees are *not* reduced by the lender paid fees – so that the broker is paid twice for the same services, increasing the overall cost of the loan to the borrower. The supposed reduction in closing costs in exchange for the yield spread premium rarely occurs. Generally the borrower ends up paying both the closing costs and the higher interest rate caused by the yield spread premium. This practice occurs both in the prime and subprime mortgage market.

Pursuant to Congress's directive to HUD in 1998 to write a Statement of Policy, consumer representatives worked with the mortgage industry and HUD to develop the language.[3] One of the reasons that consumer representatives agreed with the Statement of Policy that was issued by HUD in 1999 was the explicit direction provided to the industry on how to avoid challenge for the lender's payment of a broker fee:

> Mortgage brokers and lenders can improve their ability to demonstrate the reasonableness of their fees if the broker discloses the nature of the broker's services and the various methods of compensation at the time the consumer first discusses the possibility of a loan with the broker.
>
> . . .

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used the services of a mortgage broker to obtain an FHA loan. Despite her credit rating which qualified her for a 7% fixed rate loan, and the fact that she paid the broker a $1,544 as a loan broker fee, and loan discount points of $4,736, the broker "upsold" her into a 7% variable rate loan. By increasing the cost of the loan to Ms. Hiers, the broker received an additional $4,539 as a lender paid broker fee. Ms. Hiers paid the broker a total of $10,819 in fees on a $159,570 loan – almost 7% of the loan amount.

[3]"The conferees expect HUD to work with representatives of industry, Federal agencies, consumer groups, and other interested parties on this policy statement."*See* the Conference Report on the Departments of Veterans Affairs and Housing an Urban Development, and Independent Agencies Appropriations Act, 1999, H.R. Conf. Rep. No. 1050769 at 260 (1998).

> [T]he most effective approach to disclosure would allow a prospective borrower to properly evaluate the nature of the services and all costs for a broker transaction, and to agree to such services and costs before applying for a loan. Under such an approach, the broker would make the borrower aware of . . . the total compensation to be paid to the mortgage broker, including the amounts of each of the fees making up that compensation. If indirect fees are paid, the consumer would be made aware of the amount of these fees and their relationship to direct fees and an increased interest rate. If the consumer may reduce the interest rate through increased fees or points, this option also would be explained.(Emphasis added.)[4]

With this clear direction on how to avoid liability for paying broker fees, one would think that the mortgage industry would immediately adopt these recommendations and employ them in all future loans. One would be wrong. Instead the industry continued as before – lenders continued to pay broker fees without evaluating either the services provided by the broker or whether the payment of the lender fee reduced the fees otherwise owed by the borrower. The strategy of the mortgage industry was to pay off the few individual actions and mount a massive effort to fight class certification of any case challenging the payment of these fees.

***Culpepper* Case**

After the issuance of the 1999 Statement of Policy most federal courts generally denied class certification, requiring an intensely factual analysis to determine legality,[5] while a few federal district courts did permit the class actions to proceed.[6] This scene changed significantly however, when the 11th Circuit Court of Appeals issued a comprehensive analysis of RESPA's requirements regarding referral fees, the 1999 Statement of Policy, and upheld class certification, on June 15, 2001.[7]

The crux of the analysis in the *Culpepper* case is that for HUD's Statement of Policy to be consistent with RESPA, a two part test is necessary to determine the legality of the lender paid broker fees. First, whether the lender paid fee was *for* goods, services or facilities provided.

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[4]Real Estate Settlement Procedures Act Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers. 64 FR 10080 (March 1, 1999) at 10087.

[5]*See e.g. Golan v. Ohio Sav. Bank,* 1999 U.S. Dist. LEXIS 16452 (N.D. Ill. Oct. 15, 1999); *Brancheau v. Residential Mortgaeg,* 187 F.R.D. 591 (D. Minn. 1999); *Levine North Am. Mortgage,* 188 F.R.D. 320 (D. Minn. 1999); *Smitz v. Aegis Mortgage Corp.,* 48 F. Supp. 2d 877 (D. Minn. 1999).

[6]*Heimmermann v. First Union Mortgage,* 188 F.R.D. 403 (N.D. Ala. 1999); *Briggs v. Countrywide Funding Corp.,* 188 F.R.D. 645 (M.D. Ala. 1999).

[7] *Culpepper v. Irwin Mortgage Corp.* 253 F. 3d 1324 (11th Cir. 2001).

Second, whether the total fee paid was reasonable.[8] The court found class certification appropriate because -

> the terms and conditions under which a lender pays the broker a yield spread premium can determine whether the yield spread premium is compensation for referring loans rather than a bona fide fee for services. There is no suggestion from the evidence or the argument here that Irwin negotiates yield spread premiums loan-by-loan, rather than paying them according to terms and conditions common to all the loans.[9]

As the first step of the two part test - whether the lender paid fee was *for* services - could be answered without performing a factual analysis of each individual loan, the court found no reason that the case could not proceed as a class action. The court noted that the formula by which a lender paid broker fee is paid "does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker services."[10]

Industry Position

The mortgage industry has consistently stated that it wants to ensure that yield spread premiums remain legal so that borrowers can benefit from their use - such as by reducing the up-front closing costs required to be paid from cash or equity. Yet, there have been no changes in policy or practice which would dictate that a lender fee should only be paid when there was a determination that this was the case.

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[8]A significant basis for this rationale is not only HUD's 1999 Statement of Policy, but also the language of RESPA's provision distinguishing between legal fees and referral fees. Section 8(c) of RESPA permits "the payment of a fee . . . by a lender . . . *for services actually performed.*" 12 U.S.C. § 2607(c)(1)(C). 253 F. 3d at 1328. (Emphasis added.)

[9] 253 F. 3d at 1329.

[10] The factual basis for the court's conclusion was stated in this way:

The "yield spread premiums" at issue in this case . . . are payments from [the lender] to its mortgage brokers that the written agreement between them contemplates, but does not define. Each business day, Irwin distributes a rate sheet to its brokers, listing the terms of the loans Irwin is offering that day. The loans' interest rates are set with reference to a "par rate." If the broker originates a loan at a below-par rate, it gets no compensation from Irwin. On the other hand, originating a loan at an above-par rate garners the broker a yield spread premium, whose amount is determined by a formula that includes the amount of the loan and the difference between the loan rate and the par rate. The formula does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker's services. 253 F.3d at 1325.

The mortgage industry responded to the *Culpepper* case by immediately going to HUD and seeking a "clarification" of the 1999 Statement of Policy removing all references to language which would support the 11th Circuit court's analysis. The stated rationale was simply to "clarify" the "ambiguity" in the Policy Statement.[11] Despite the fact that the 1999 Statement of Policy was unambiguous regarding how the industry could legally pay yield spread broker fees, the industry coyly requested:

> HUD must issue decisive and clear rules that benefit both borrowers and lenders by creating a regulatory environment in which consumers can make informed choices and lenders can operate their businesses, without the constant prospect of having industry practices that benefit consumers challenged in litigation.[12]

The industry portrayed a "clear rule" for the future as an appropriate trade-off for the requested "clarification of the 1999 Statement of Policy."[13] This completely ignored the obvious – that HUD had already provided a clear rule, just as the industry is now requesting, in the 1999 Statement of Policy, which the industry had simply ignored.

HUD's Actions

In the weeks preceding the issuance of the 1999 Statement of Policy, HUD officials met with consumer representatives on dozens of occasions to work through many of the complex issues involved in this problem. Many of these meetings were also attended by representatives of the mortgage industry. In contrast, prior to the 2001 Statement, HUD officials met with consumer representatives three times, despite numerous requests and offers by these representatives to engage in a more substantial dialogue.[14]

The consumer representatives tried to make clear to HUD officials these essential points:

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[11] ***See*** **letter from Anne Canfield, Executive Director of the Consumer Mortgage Coalition, to Secretary Mel Martinez, dated September 25, 2001. http://www.houselaw.net/alerts/092801a.pdf.**

[12] ***Id.***

[13] ***See*** **memorandum from Howard Glaser, Mortgage Bankers Association, entitled "What we are asking for."**

[14] **On July 11, 2001 consumer representatives met with General Counsel Richard Hauser and other HUD representatives. On September 11, 2001 consumer representatives met for a few minutes with Secretary Martinez, FHA Commissioner Weicher, Mr. Hauser, and others. Given the tragic occurrences of the day, this meeting was aborted and resumed on September 19. On October 11, after numerous requests, consumer representatives again met with Mr. Hauser, Commissioner Weicher, and others.**

- Providing the "clarification" of the 1999 Statement as sought by the mortgage industry would have the effect of completely eliminating class actions as a form of redress for illegal lender paid broker fees.[15]
- Without class actions as a means to litigate the legality of these fees, the industry has no incentive to change their practices or even to comply with a new regulation – because there are insufficient legal resources in this nation to represent consumers in individual actions involving claims of only a few thousand dollars.
- The "new" disclosures offered by the industry – and proposed by HUD – provide *fewer* actual protections for consumers than those recommended by HUD in the 1999 Policy Statement. Unlike the 1999 recommendations which include the consumer's *agreement* to the lender paid broker fee, the 2001 proposal only mentions "disclosure."[16]
- Limiting illegal lender paid broker fees is an essential step in redressing predatory mortgage lending.

The mortgage industry provided specific language to HUD to "clarify" the 1999 Policy Statement. HUD adopted every recommendation made by the industry. The crux of HUD's "clarification" comes on page 11, with the statement:

> HUD's position is that in order to discern whether a yield spread premium was for goods, facilities or services under the first part of the HUD test, it is necessary to look at each transaction individually. . .[17]

Such a position, if deferred to by the courts, would almost certainly preclude class action suits, thus removing the only effective legal recourse to challenge this practice. In fact the 2001 Statement of Policy collapses the two-part test articulated in the 1999 Statement into a single analysis; which represents a serious departure from not only the 1999 Statement, but the Congressional directive in RESPA.[18]

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[15]This assumes that a court agrees that the 2001 HUD Statement of Policy should be provided deference. There is substantial legal question regarding the extent of reliance that a court may place on an agency's interpretative statement which has not been subject to notice and comment. The Supreme Court has distinguished between the deference due regulations promulgated by formal notice-and-comment rulemaking or formal adjudications and those made informally. *See Christensen v. Harris County*, 529 U.S. 576, 120 S. Ct. 1655, 1662, 146 L. Ed. 2d 621 (1999).

[16]Consumer representatives maintain that requiring the consumer to *agree* to the payment of a lender paid broker fee is an essential element in a regulatory structure that would truly protect consumers from illegal yield spread premiums.

[17]Department of Housing and Urban Development, RESPA Statement of Policy 2001-1:Clarification of Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b) at 11.

[18]The new test "requires that total compensation to the mortgage broker be reasonably related to the total set of goods or facilities actually furnished or services performed." *Id.* at 13. Although HUD *says* there

HUD's action is absolutely crippling to consumer rights, as it removes any incentive the industry has to cooperate with any future action that HUD might take to address the egregious practice of upselling mortgage loans. In his press release, Secretary Martinez claims to be pursuing a reform to require full up-front disclosure of all total compensation to be paid to the broker. However, even if HUD initiates a proposed rulemaking to do this (which was not proposed in the October 15 Statement), and even if the regulation goes beyond the meaningless recommendations in the 2001 Statement, it will be a regulation without any effective enforcement mechanism.

There are no shades of gray in HUD's action of October 15, 2001: the mortgage industry requested and received everything it wanted to enable it to avoid past and future liability for blatantly ignoring REPSA's prohibitions against referral fees. HUD's gift to the mortgage industry will be paid for by American homeowners.

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is still a two part test, the two tests appear identical.